THE BUDGET OUTLOOK AND ITS ECONOMIC IMPLICATIONS

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THE BUDGET OUTLOOK AND ITS ECONOMIC IMPLICATIONS

THURSDAY, OCTOBER 10, 1985

House of Representatives,
Committee on the Budget,
Washington, DC.

The committee met, pursuant to notice, at 9:25 a.m., in room 210, Cannon House Office Building, Hon. William H. Gray III (chairman of the committee) presiding.

The Chairman. The committee will now come to order. Today we continue our hearings examining topics of crucial importance to the country. Today we will have an overview of the economic and budget outlook and the impact of the Federal deficit on the economy in the future. In 2 days of hearings next week we will take a closer look at the impacts on specific sectors of the economy: Manufacturing, farming, and trade.

To begin this hearing we are pleased to welcome Dr. Rudy Penner, Director of the Congressional Budget Office. At 11 o'clock we will be hearing from a panel of three distinguished economic forecasters, who will share their views with us.

Dr. Penner, I am glad to have you lead off this morning. I expect that CBO will provide its usual excellent guidance through the thicket of economic statistics and arguments, so that we will have a clear view of the situation.

After the Senate action on the Gramm-Rudman budget plan yesterday, it is most important that we know the true magnitude of the deficit problem and understand the economic environment we will be facing. At yesterday's hearing we learned some of the economic and political dangers of this plan which was rushed through the Senate with what I consider very little consideration.

Today, we hope to get back to the task of making economic policy on the basis of informed judgments, not wishful thinking.

We welcome you, Dr. Penner, to the House Budget Committee. Before you begin your testimony, I would like to call upon the distinguished gentleman from Ohio, the ranking member from the minority side, Mr. Latta, for a few opening comments.

Mr. Latta. Thank you very much, Mr. Chairman.

Dr. Penner, it is always good to have you before this committee to hear you testify. Looking at the testimony given to us, maybe we could expedite it by you summarizing your statement. I am sure that we have a lot of questions about the proposal that just passed the Senate. Maybe you can answer some of those questions.

The Chairman. Thank you, Congressman Latta.

Dr. Penner, as is our usual situation, we have a copy of your testimony, and we will glad to enter it into the record in its entirety. We would hope that you might summarize your comments in about 5 to 7 minutes, which would leave us a greater period of time to ask questions. Please proceed.

STATEMENT OF RUDOLPH G. PENNER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. PENNER. Thank you very much, Mr. Chairman.

This testimony was prepared before the actions on the Gramm-Rudman-Hollings proposal, but obviously I would be pleased to get into that if you wish.

Looking at the broad picture of the economy and the budget, as you know, the U.S. economy has been weaker so far this year than most forecasters anticipated. In mid-1984, its growth slowed abruptly, and continued at a sluggish pace in the first three quarters of this year. This weak growth has kept unemployment quite high by historical standards, and capacity utilization low. Inflation rates, however, remain at the relatively moderate levels achieved soon after the 1981-82 recession.

The slowdown this year resulted primarily from a reduction in inventory investment and a further decline in net exports. Although domestic demands remain strong, foreign competition has made heavy inroads in the goods producing sector of the U.S. economy. This deterioration in the competitive position of U.S. producers is related, in part, to the growth in the Federal deficit in recent years. The deficit helped to push up interest rates in the United States, thus attracting inflows of international capital that contributed to the rise in the exchange values of the dollar and the resulting decline in net exports.

Massive inflows of foreign capital into the United States and the concomitant rise in our country's external debt have altered the nature of the longrun costs of persistent large budget deficits. Without such inflows, enormous borrowing requirements of the Federal Government would have crowded out private borrowers, thus leading to reduced business investment and lower productivity growth. The end result would have been slower improvement of living standards. Instead, inflows of foreign capital in recent years have mitigated the crowding out effects of Federal deficits and their depressing influence on productivity.

Rising external indebtedness of the United States necessitates, however, diverting an increasing share of domestic output toward servicing the external debt. The end result, therefore, will be slower growth of Americans' living standards than what could have been achieved with smaller budget deficits.

More forecasters, including the Congressional Budget Office [CBO] now expect a speedup in output growth later this year, followed by moderate growth in 1986. The reason for these expectations is a sharp drop in interest rates, particularly in response to an expansive monetary policy. Furthermore, the recently enacted congressional budget resolution for fiscal year 1986 signficantly reduces the size of future budget deficits, leading to expectations of reduced future credit demands and an anticipatory lowering of long-term interest rates. Lower interest rates are likely to encourage growth in interest-senstive sectors such as residential construction and business investment.

The dollar has also declined recently, thereby improving the prospect for halting the deterioration of net exports next year. Monetary authorities of the five largest industrial countries have recently come to an accord aimed at weakening the dollar on international exchanges, which may further contribute to the improvement in U.S. net exports.

Nevertheless, the economic outlook remains cloudy. Although the Commerce Department's flash report on the economy suggests that growth did accelerate somewhat in the third quarter, so far there are only a few signs of an imminent resumption of robust economic growth. Furthermore, the financial system appears to be coming under increasing stress; the international debt situation is not improving; economic growth in the rest of the world remains lackluster; and protectionist pressures are mounting.

On the other hand, final sales still remain relatively strong; oil prices may weaken further; economic performances of the United States and its leading trading partners are likely to converge; and, most important, the congressional budget resolution for fiscal years 1986-89, although leaving deficits high by historical standards, has changed the budgetary outlook for the better. In contrast to CBO's projections last February of deficits rising to the neighborhood of $300 billion by 1990, we now project that, if the resolution is fully implemented, Federal deficits will gradually decline from $210 billion this year to $120 billion in 1990.

My complete testimony, Mr. Chairman, goes into all of these matters in considerably more detail. I think it important to reiterate that the budget resolution, as evidenced by a chart your staff put up there, really radically changes our deficit outlook for the better. No massive cuts have been made in those deficits, however, and they still remain extraordinarily high by any historical comparison.

So I would characterize this budget resolution as something that has accomplished a great deal, but not enough to make us immune from various risks facing the economy and the budget. In other words, there is no room for Murphy's law here. If things go wrong, we could be in a very bad situation again. With that I will conclude, Mr. Chairman, and take your questions.

[Testimony resumes on p. 27.]

[The prepared statement of Mr. Penner follows:]

PREPARED STATEMENT OF RUDOLPH G. PENNER

Mr. Chairman, I am pleased to have the opportunity to testify on the economic and budgetary outlook. As you know, the U.S. economy has been weaker so far this year than most forecasters anticipated. In mid-1984, its growth slowed abruptly and continued at a sluggish pace in the first three quarters of this year. This weak growth has kept unemployment quite high by historical standards, and industrial capacity utilization low. Inflation rates, however, remain at the relatively moderate levels achieved soon after the 1981-1982 recession.

The slowdown this year resulted primarily from a reduction in inventory investment and a further decline in net exports. Although domestic demands remain strong, foreign competition has made heavy inroads in the goods producing sector of the U.S. economy. This deterioration in the competitive position of U.S. producers is related, in part, to the growth in the federal deficit in recent years. The deficit helped to push up interest rates in the United States, thus attracting inflows of international capital that contributed to the rise in the exchange values of the dollar and the resulting decline in net exports.

Massive inflows of foreign capital into the United States and the concomitant rise in our country's external debt have altered the nature of long-run costs of persistent large budget deficits. Without such inflows, enormous borrowing requirements of the federal government would have crowded out private borrowers, thus leading to reduced business investment and lower productivity growth. The end result would have been slower improvement of living standards. Instead, inflows of foreign capital in recent years have mitigated the crowding out effects of federal deficits and their depressing influence on productivity.

Rising external indebtedness of the United States necessitates, however, diverting an increasing share of domestic output toward servicing the external debt. The end result, therefore, will be slower growth of Americans' living standards than what could have been achieved with smaller budget deficits.

Most forecasters, including the Congressional Budget Office (CBO), now expect a speedup in output growth later this year, followed by moderate growth in 1986. The reason for these expectations is a sharp drop in interest rates, partly in response to an expansive monetary policy. Furthermore, the recently enacted Congressional Budget Resolution for Fiscal Year 1986 significantly reduces the size of future budget deficits, leading to expectations of reduced future credit demands and an anticipatory lowering of long-term interest rates. Lower interest rates are likely to encourage growth in interest-sensitive sectors such as residential construction and business investment.

The dollar has also declined recently, thereby improving the prospect for halting the deterioration of net exports next year. Monetary authorities of the five largest industrial countries have recently come to an accord aimed at weakening the dollar on international exchanges, which may further contribute to the improvement in U.S. net exports.

Nevertheless, the economic outlook remains cloudy. Although the Commerce Department's flash report on the economy suggests that growth did accelerate somewhat in the third quarter, so far there are only a few signs of an imminent resumption of robust economic growth. Furthermore, the financial system appears to be coming under increasing stress; the international debt situation is not improving; economic growth in the rest of the world remains lackluster; and protectionist pressures are mounting. On the other hand, final sales still remain relatively strong; oil prices may weaken further; economic performances of the United States and its leading trading partners are likely to converge; and, most important, the Congressional Budget Resolution for Fiscal Years 1986-1989, although leaving deficits high by historical standards, has changed the budgetary outlook for the better. In contrast to CBO's projections last February of deficits rising to the neighborhood of $300 billion by 1990, we now project that, if the resolution is fully implemented, federal deficits will gradually decline from $210 billion this year to $120 billion in 1990.

In a report issued last August entitled The Economic and Budget Outlook: An Update, the Congressional Budget Office (CBO) provided this committee with revised economic and budget estimates. My testimony today will summarize and update that report.

RECENT ECONOMIC DEVELOPMENTS

The economy has recorded only 2.3 percent growth in real gross national product (GNP) over the last year and a sluggish 1.7 percent average increase, at annual rates, for the first three quarters of 1985. Unemployment has held steady for a year at rates slightly above 7 percent (see Table 1).

The slowdown in output growth in the first half of this year resulted from further deterioration in net exports and a decline in inventory accumulation rather than from weak domestic demands. In fact, private demands have been quite strong (see Figure 1). Real final sales to domestic purchasers grew at a 4.6 percent rate during the first half of this year, with consumer spending rising at a strong 5.0 percent rate and business fixed investment at a 6.2 percent rate.

The divergence between the rate of growth of domestic demand and domestic output is one reflection of the stimulative effects of federal budget deficits and the depressing effects of trade deficits. It is generally understood by now that increased federal deficits have been crucially important in creating record-breaking trade deficits. Data suggest that until mid-1984 the increasing drag on the economy originating in the external sector was more than offset by stimulative effects of strong fiscal expansion. More recently, however, the negative effects of rapidly deteriorating net exports appear to have dominated fiscal policy impacts, thus depressing overall U.S. economic performance and noticeably affecting the composition of the American economy.

As a result of strong domestic demand, those sectors of the economy

TABLE 1. RECENT ECONOMIC INDICATORS

Indicator	1983	1984	1984 III	1984 IV	1985 I	1985 II	1985 III
Real GNP (percent change)	3.7	6.8	1.6	4.3	0.3	1.9	2.8 a/
Real final sales to domestic purchasers	4.4	6.8	2.9	4.3	3.4	5.9	N.A.
Personal consumption expenditures	4.8	5.3	0.7	3.6	5.2	4.8	N.A.
Business fixed investment	2.5	19.8	13.7	8.5	-1.6	14.5	N.A.
Residential investment	41.7	12.2	-4.6	-5.5	5.3	6.4	N.A.
Government purchases	-0.3	3.5	5.4	5.9	0.3	3.7	N.A.
Inventory change (billions of 1972 dollars)	-3.6	24.8	30.6	16.8	19.1	8.3	N.A.
Industrial Production (percent change)	5.9	11.5	6.4	-0.6	2.1	1.4	1.6 a/
Civilian Unemployment Rate	9.6	7.5	7.5	7.2	7.3	7.3	7.2
Consumer Price Index, Urban Consumers (percent change)	3.2	4.3	3.7	3.5	3.3	4.2	2.5 a/
Three-Month Treasury Bill Rate	8.6	9.5	10.3	8.8	8.2	7.5	7.1
Corporate Bond Rate	12.0	12.7	13.0	12.4	12.3	11.6	11.0

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

N.A. = not available.

a. Based on incomplete or preliminary data.

that are relatively immune to foreign competition continued to thrive--namely, most services or defense oriented industries. At the same time, industries producing tradeable goods have suffered a drop in their output. The purchases-based goods component of GNP declined in the first half of this year, suggesting a decline in GNP goods output. Moreover, industrial production rose only at a 1.7 percent annual rate from January through August. Payroll employment data indicate that employment in goods producing industries has declined by 163,000 since the beginning of the year. On the other hand time, employment in service producing industries, which are not threatened significantly by foreign competition, has risen over 1.8 million.

Inflation rates in the first half of this year were about the same as for 1984 as a whole. The Consumer Price Index rose at about a 3.3 percent rate from December to August, while the Producer Price Index for finished goods increased at about a 0.8 percent rate. Factors contributing to the moderate inflation were: the high dollar, which cuts the price of imports and restrains price increases for import competing products; continuing weakness in oil prices; abundant crops and low food prices; and low average wage increases. Given the current slack in the economy and the likelihood of further declines in oil prices, most forecasters do not expect inflation rates to rise significantly above current levels during the next several months.

Both real and nominal interest rates continued to ease through July and remained about flat in the past three months. The three-month Treasury bill rate has fallen three percentage points since last summer, and long-term Treasury bond rates are also down sharply. While the weakened state of the economy undoubtedly was a factor in this decline in rates, it also reflected a more expansive monetary policy and, perhaps, the expectation of reduced future credit demands on the part of the federal government.

Continued moderate inflation, reduced interest rates, and the significant decline in the dollar over the past six months have improved the prospects for a pickup in economic activity. The near-term outlook is, however, very uncertain. Indicators of domestic output are mixed and the outlook for the foreign trade sector is particularly uncertain.

THE CBO ECONOMIC PROJECTION

CBO's economic projection that is used to construct budget estimates consists of: (1) an economic forecast through 1986 that is conditional on specific policy assumptions; and (2) medium-term economic projections through 1990 based on historical growth trends.

The Forecast for 1985 and 1986

The short-run CBO forecast shown in Table 2 incorporates the following assumptions:

- Federal budget policies are assumed to be those incorporated in the Congressional Budget Resolution for 1986.
- CBO's economic forecast of last August assumed that the Federal Reserve would increase the monetary aggregates at rates corresponding to the middle of the target ranges announced by the Federal Reserve in its mid-year report to Congress and that the demand for narrowly defined money balances (M1) would increase

slightly faster than GNP. Since the time of our forecast, the demand for money balances has grown at a surprisingly rapid rate and the Federal Reserve has accommodated this surge. Without this change, it is unlikely that the originally assumed policy would have been consistent with our August economic forecast.

- Food prices are assumed to rise less than prices in general, and oil prices are assumed to decline by about $2.50 per barrel from calendar year 1984 to 1986.

- In its forecast of last August, CBO assumed that the exchange rate of the dollar falls by some 8 percent from its average level in the second quarter of 1985 and remains roughly stable through the forecast period. The recent agreement of the Group of Five depressed the dollar a few percentage points below the level forecast by CBO in August. We now assume that the average value of the dollar in international exchange markets will remain approximately at today's levels.

TABLE 2. THE CBO FORECAST FOR 1985 AND 1986

	Actual		Forecast	
	1983	1984	1985	1986
Fourth Quarter to Fourth Quarter (percent change)				
Nominal GNP	10.4	9.5	7.0	7.8
Real GNP	6.3	5.7	2.6	3.4
Fixed-Weight GNP Deflator	4.0	4.2	4.1	4.3
Consumer Price Index Urban consumers	3.3	4.1	3.9	4.8
Calendar Year Average (percent)				
Civilian Unemployment Rate	9.6	7.5	7.2	7.0
Three-Month Treasury Bill Rate	8.6	9.5	7.6	7.4
Corporate Bond Rate (Moody's AAA)	12.0	12.7	11.5	10.7

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Board; Congressional Budget Office.

With these assumptions and taking into account the economic results of the first half of this year, CBO adjusted the forecast it made last February by lowering the rate of GNP growth for 1985 by about one percentage point and slightly raising it for 1986. Inflation, as measured by the Consumer Price Index (CPI-U), has been about in line with our February forecast. The rate of inflation is expected to be between 3½ percent and 4 percent this year and to accelerate to between 4½ percent and 5 percent in 1986. The increase in CPI-measured inflation from 1985 to 1986 reflects a lagged response to the decline in the dollar and exceptionally low inflation in food prices so far in 1985 (the latter is not expected to be repeated next year). The civilian unemployment rate is projected to decline gradually from current levels. The three-month Treasury bill rate is expected to average about 7½ percent in 1985 and 1986--about two percentage points below last year's average rate. Corporate bond rates are projected to fall about a percentage point in 1985, to 11½ percent, and still further in 1986 to 10½ percent.

Economic Projections for 1987-1990

The medium-term projections, shown in Table 3 and Figure 1, are based on average historical experience. Specifically, the growth rates for real GNP and productivity from the fourth quarter of 1982 (the recession trough) to the fourth quarter of 1990 are assumed to equal their respective average growth rates in the eight-year periods following earlier postwar recessions. Thus, these growth- and interest-rate paths do not necessarily reflect the budget policies incorporated in the Budget Resolution for Fiscal Year 1986. The major characteristics of the 1987-1990 projections are:

- Real GNP grows smoothly at an average 3.5 percent rate;
- The unemployment rate declines gradually to 6.3 percent by 1990;
- Inflation holds at about 4.2 percent, close to current levels; and
- Interest rates also remain flat at 7.2 percent for the Treasury bill rate and 10.2 percent for the corporate bond rate. The inflation-adjusted Treasury bill rate is assumed to be 3 percent, somewhat lower than the real rate assumed last February.

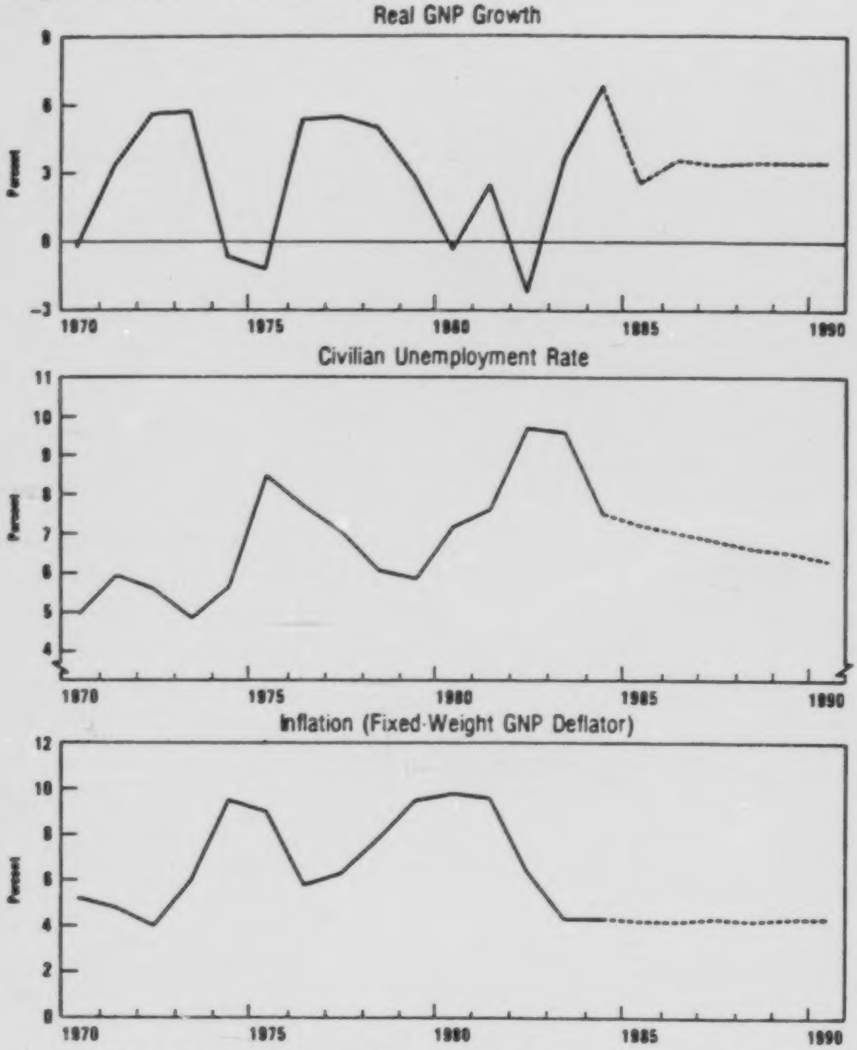
TABLE 3. ECONOMIC ASSUMPTIONS

Economic Variable	Actual 1984	1985	1986	1987	1988	1989	1990
			Economic Assumptions (By calendar year)				
Real GNP (percent change)	6.8	2.6	3.6	3.4	3.5	3.5	3.5
CPI-U (percent change)	4.3	3.7	4.5	4.4	4.2	4.2	4.2
Civilian Unemployment Rate	7.5	7.2	7.0	6.8	6.6	6.5	6.3
Three-Month Treasury Bill Rate	9.5	7.6	7.4	7.2	7.2	7.2	7.2

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Board; Congressional Budget Office.

Figure 1.

Major Economic Assumptions


Real GNP Growth

Civilian Unemployment Rate

Inflation (Fixed-Weight GNP Deflator)

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Congressional Budget Office.

UNCERTAINTY IN THE FORECAST

At present, the greatest uncertainty appears to be related to the following factors: condition of financial institutions, mounting protectionist pressures, behavior of the dollar, and changes in world oil prices.

In regard to financial conditions, two sources of uncertainty now appear paramount. First, the historical relationship between certain monetary aggregates and economic activity appears to be shifting. In the last four years, there have been two periods of unexpected and unprecedented decline in money velocity (the ratio of GNP to money); the most recent decline occurred in the first three quarters of this year. This instability in money velocity makes it much more difficult for outside forecasters and the Federal Reserve to predict the effects of its policy on the economy.

Second, the failure rate of domestic financial institutions is very high. Many farm banks have experienced serious difficulties and the Farm Credit System has come under increasing strain as a result of the deteriorating quality of its assets. Increasingly poor quality of assets has also become the most pressing problem for many savings institutions. In addition these institutions remain vulnerable to rising interest costs because of a mismatch in the maturities of their assets and liabilities. Debt-burdened developing countries are also vulnerable to a rise in interest rates. A widespread failure of financial institutions or an inability of foreign debtors to service their debt could create serious economic uncertainty, perhaps having significant budgetary implications, and could force the Federal Reserve to relax its anti-inflationary policy stance.

Escalation of protectionist pressures around the world could have incalculable consequences for the American and the world economies. Should they trigger a cascade of retaliatory and counter-retaliatory measures, the outcome would be a sharp contraction of international trade accompanied by a pronounced slowdown in economic growth.

The economic outlook would be significantly affected by an abrupt shift in the dollar exchange rate. If the international value of the dollar were to rise, despite the stated commitments of the five largest industrial countries to weaken it, the U.S. foreign trade position would be likely to keep deteriorating, perhaps even jeopardizing further expansion. On the other hand, if the dollar were to fall sharply, inflation in the United States would be higher, but the U.S. trade position would become stronger.

A major drop in oil prices would also have a significant effect on the economic situation. Indeed, some forecasters expect that oil prices will decline more sharply than assumed by CBO. Such a decline would have a favorable effect on both inflation and economic growth in the United States and other oil importing countries.

Many analysts predict a decline in the value of the dollar as well as in energy prices. If this should happen, the deflationary effects of falling energy prices would tend to offset the inflationary effects of a falling dollar. But the effects on real activity might be reinforcing--both tending to increase domestic output.

THE BUDGETARY OUTLOOK

The budgetary outlook has changed dramatically since the beginning of the year as the result of the new Congressional budget plan for fiscal years 1986-1988. Assuming that this plan is implemented fully, and extrapolating its policies through 1990, CBO projects that federal deficits would fall from $210 billion this year to $175 billion in 1986, $143 billion in 1988, and $120 billion in 1990. The decline in the deficit appears even larger in relation to the size of the economy. Under CBO's economic assumptions, the deficit will shrink from 5.5 percent of the gross national product in 1985 to 2.1 percent by 1990, the lowest level experienced since 1979.

These budget projections are in sharp contrast to those that we made in February in our annual report to the Budget Committees. At that time, CBO was projecting deficits rising to the neighborhood of $300 billion by 1990 and remaining above 5 percent of GNP throughout the projection period. While some have expressed disappointment that the Congress did not go further in its plan to reduce the deficit and while it is true that much remains to be done, I believe that implementing the budget resolution would, nevertheless, represent significant progress. Given our assumptions, one of its most important outcomes is that the resolution would halt the rapid escalation of federal debt relative to GNP. According to our estimates, the debt-to-GNP ratio would peak at 41.7 percent in 1987 and then decline to 40.2 percent by the end of 1990, as shown in Figure 2. This should help to

TABLE 4. THE BUDGET OUTLOOK WITH POLICIES OF THE 1986 BUDGET RESOLUTION (By fiscal year)

	1984 Actual	1985 Estimate	CBO Projection 1986	1987	1988	CBO Extrapolation 1989	1990
			In Billions of Dollars				
Revenues	666	737	790	858	939	1,013	1,094
Outlays	852	946	965	1,021	1,082	1,145	1,214
Deficit	185	210	175	163	143	132	120
Debt Held by the Public	1,313	1,522	1,701	1,861	2,002	2,133	2,252
			As a Percent of GNP				
Revenues	18.6	19.2	19.1	19.2	19.5	19.5	19.5
Outlays	23.8	24.6	23.3	22.9	22.5	22.1	21.7
Deficit	5.2	5.5	4.2	3.7	3.0	2.5	2.1
Debt Held by the Public	36.7	39.6	41.1	41.7	41.6	41.1	40.2

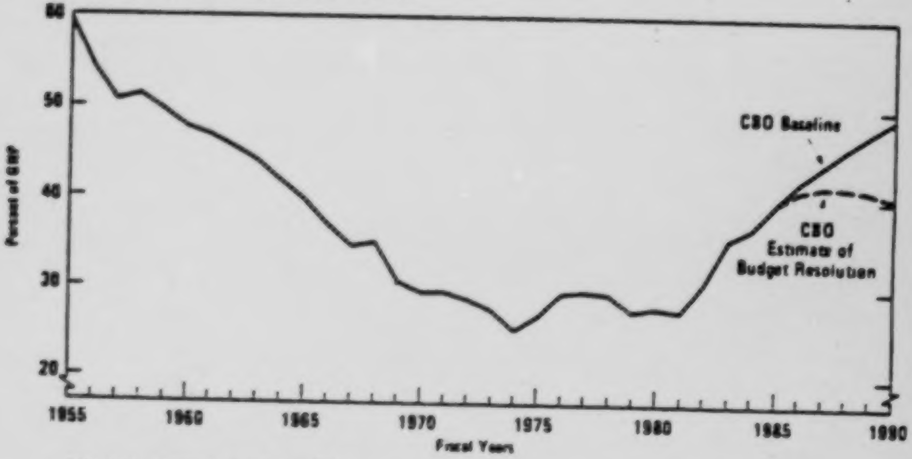
SOURCE: Congressional Budget Office.

ease pressures on interest rates and have favorable effects for both the economy and the budget.

The projected improvement in the deficit and debt picture does not mean, however, that all fiscal problems will disappear. The remaining deficits are still high by historical standards. Furthermore, publicly held federal debt would grow by nearly 50 percent during the next five years, requiring a larger share of the budget to be allocated to debt service costs. Finally, these projections depend critically on the Congress following

Figure 2.

Federal Debt Held by the Public



SOURCE: Congressional Budget Office

[a] Extrapolated by CBO in 1989 and 1990

through with legislative actions necessary to implement the budget resolution policies, and the economy performing as assumed by CBO. In other words, the resolution does not provide any insurance against things going wrong.

Policy Changes

The budget resolution relies almost entirely on spending reductions to achieve lower deficits. Only very small revenue increases from projected baseline levels are contemplated. Table 5 summarizes the deficit reductions in the budget resolution in terms of changes from CBO's updated baseline projections.

TABLE 5. POLICY CHANGES IN THE 1986 BUDGET RESOLUTION AS ESTIMATED BY CBO (By fiscal year, in billions of dollars)

	CBO Projection			CBO Extrapolation	
	1986	1987	1988	1989	1990
CBO Baseline Deficit a/	212	229	243	264	285
Deficit Reductions as estimated by CBO					
Revenue increases b/	-3	-5	-8	-11	-11
National defense	-11	-25	-41	-57	-74
Entitlements	-7	-13	-18	-19	-20
Nondefense discretionary	-11	-20	-24	-24	-26
Offsetting receipts	-4	c/	c/	-1	-1
Net interest	-1	-3	-10	-20	-33
Total reductions	-37	-66	-100	-132	-164
Deficit in Budget Resolution as Estimated by CBO	175	163	143	132	120

a. CBO February 1985 baseline, as updated in August.

b. Revenue increases appear as negative numbers because they reduce the deficit.

c. Less than $500 million.

The largest spending reductions compared with earlier policy are for national defense--$11 billion in 1986, $41 billion in 1988, and $74 billion in 1990. The budget resolution allows defense budget authority to keep pace with inflation in 1986, and provides for real increases of about 2 percent a year thereafter under CBO economic assumptions. Spending for entitlement programs--notably Medicare, general revenue sharing, and farm price supports--is to be reduced by $7 billion in 1986, $18 billion in 1988, and

$20 billion by 1990. Proposed reductions in nondefense discretionary spending amount to $11 billion in 1986, $24 billion in 1988, and $26 billion in 1990. Finally, net interest outlays are lowered by $1 billion in 1986, $10 billion in 1988, and $33 billion in 1990 because of the reductions in projected deficits.

It is too early to tell how successful the Congress will be in implementing the budget resolution policy changes. The resolution contained reconciliation instructions to various House and Senate committees to prepare legislation to achieve $75 billion in deficit reductions in 1986-1988. These instructions cover about half of the assumed revenue increases and virtually all of the reductions in spending for entitlements and other mandatory programs.

Even larger savings are to be achieved through the authorization-appropriation process. Based on action taken to date, it would appear that 1986 appropriations for national defense and nondefense discretionary programs generally will be in line with the budget resolution targets. The most notable achievements to date has been the action on the defense authorization bill and the agreement by the Administration to the budget resolution spending targets for defense programs.

CBO Reestimates of the Budget Resolution

Under CBO economic and technical assumptions, the deficits that would result under the policies in the budget resolution are higher than the targets specified in the resolution itself. Most of the increases in the deficit estimates are the result of using different economic assumptions. The resolution uses the economic assumptions of the Administration's February budget. CBO's latest economic forecast and longer-run assumptions project lower levels of nominal gross national product and taxable incomes than assumed for the budget resolution. This difference results in somewhat lower revenues than estimated in the resolution, by a total of $35 billion over the 1986-1988 period (see Table 6). CBO has reestimated outlays for various benefit programs, primarily because of differences in assumed rates of inflation. Finally, CBO estimate lower net interest outlays in 1986 and 1987 and higher outlays in 1988 as the result of different interest rate assumptions.

Most of the technical reestimates of the budget resolution reflect changes in baseline spending or revenue trends that have become evident during the past six months. These recent developments are not reflected in the resolution, which is generally based on CBO's February technical estimating assumptions. On the spending side, the biggest change is an increase in the cost of farm price supports that could offset the proposed savings to be achieved through legislative action.

Alternative Economic Assumptions

The CBO reestimates of the budget resolution help to demonstrate how sensitive the budget is to changes in the economy. Because of the uncertainty and risks surrounding the latest CBO economic forecast and longer-run assumptions, we have also prepared high and low paths for

TABLE 6. CBO REESTIMATES OF THE BUDGET RESOLUTION
(By fiscal year, in billions of dollars)

	1986	1987	1988
Deficit in Budget Resolution	172	155	113
CBO Economic Reestimates:			
Revenues	2	11	23
Benefit programs	-2	-1	a/
Net interest (rates)	-4	-5	3
Subtotal	-4	5	25
CBO Technical Reestimates	6	3	3
Debt Service Effect of Reestimates	a/	1	2
Total reestimates	3	9	30
Deficit in Budget Resolution as Estimated by CBO	175	163	143

a. Less than $500 million.

economic growth to illustrate further the sensitivity of budget estimates to economic conditions. These alternative paths are summarized in Table 7.

The high path assumes growth equal to that of the strongest eight-year recovery in the postwar period--that experienced in the 1960s--resulting in a growth rate from 1984 through 1990 that is about 1.2 percent higher than in the CBO economic assumptions. Because of the very rapid growth, inflation and interest rates rise rapidly in the out-years. The low path assumes growth from the end of 1984 to the end of 1990, averaging 1.2 percentage point less

TABLE 7. ALTERNATIVE ECONOMIC AND BUDGET PROJECTIONS

	1985	1986	1987	1988	1989	1990
Economic Projections (By calendar year)						
Real GNP (percent change, year over year)						
High-growth alternative	2.9	4.8	4.8	4.8	4.8	4.8
CBO economic assumptions	2.6	3.6	3.4	3.5	3.5	3.5
Low-growth alternative	2.5	1.8	-3.0	3.6	3.9	3.7
CPI-U (percent change, year over year)						
High-growth alternative	3.7	4.4	5.1	6.1	7.4	9.0
CBO economic assumptions	3.7	4.5	4.4	4.2	4.2	4.2
Low-growth alternative	3.7	4.3	3.4	2.7	2.4	2.3
Civilian Unemployment Rate (percent, annual average)						
High-growth alternative	7.2	6.7	6.2	5.7	5.3	4.9
CBO economic assumptions	7.2	7.0	6.8	6.6	6.5	6.3
Low-growth alternative	7.3	7.6	10.0	9.6	9.1	8.7
Three-Month Treasury Bill Rate (percent, annual average)						
High-growth alternative	7.2	6.7	8.1	9.6	10.9	12.7
CBO economic assumptions	7.6	7.4	7.2	7.2	7.2	7.2
Low-growth alternative	7.9	7.8	6.5	6.1	6.3	6.5
Budget Projections (By fiscal year, in billions of dollars) a/						
Deficit (-) or Surplus						
High-growth alternative	-210	-155	-117	-67	-10	72
CBO economic assumptions	-210	-175	-163	-143	-132	-120
Low-growth alternative	-210	-200	-259	-272	-256	-252

SOURCE: Congressional Budget Office.

a. CBO estimates based on the policies of the Congressional Budget Resolution for Fiscal Year 1986.

than in the CBO economic assumptions. The low path incorporates a recession beginning in mid-1986 that is equal in length and depth to the 1973-1975 recession. The weaker growth results in somewhat lower inflation and lower interest rates than in the CBO economic assumptions.

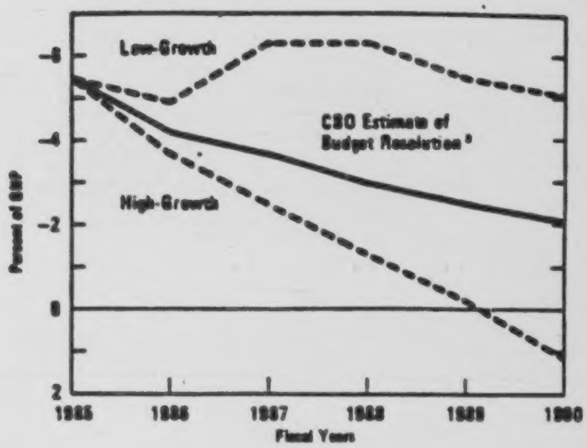
The high-growth and low-growth economic assumptions, when applied to the same budget policies (those of the Budget Resolution for Fiscal Year 1986), lead to alternative budget projections, shown at the bottom of Table 7. In the high-growth case, the deficit drops swiftly--both in dollar terms and as a percent of GNP (see Figure 3). It is nearly in balance in fiscal year 1989 and shows a surplus of about 1 percent of GNP in 1990. Under the low-growth assumptions, however, the deficit grows sharply. For example, in fiscal year 1988, the budget deficit is nearly $130 billion above the CBO estimates. Nevertheless, these alternative paths are only illustrative; they represent extremes in that the probability of exceeding the high path or falling short of the low path is extremely small. CBO economic assumptions remain, in CBO's judgment, a more reasonable basis for budget projections than either of the alternatives.

CONCLUSION

Assuming that the budget resolution policies are implemented, I believe the Congress has made considerable progress in cutting back government spending and deficits. Unfortunately, deficits still remain high and much

Figure 3

Federal Deficit Under Alternative Economic Assumptions



SOURCE: Congressional Budget Office.

[a] Extrapolated by CBO in 1989 and 1990.

remains to be done. The current projections show no room to respond easily to unexpected claims on the budget such as those that might result from an international crisis, a badly performing economy, or an emergency in our credit system.

The **Chairman**. Thank you very much, Dr. Penner.

First of all, I wish you would expand just a little bit further on the impact of the budget passed by the Congress on August 1, particularly in light of a saying that has pervaded Capitol Hill that implied that the budget resolution that was passed this year is not a significant step.

You tend to state in your opening comments that the budget resolution significantly lowers the deficit. Could you expand on that a little bit more? I know we have yet to do all the endorsement, and of course, that is contingent upon enforcement, but I would like to ask you to expand a little bit on why you think this particular budget resolution that was passed for fiscal year 1986 does help to address the problem of a growing deficit?

Mr. **Penner**. Yes, Mr. Chairman, I think there are a number of accomplishments inherent in the resolution. First of all, it is the first time since I have been at CBO at least that we can with some confidence project a deficit that declines in absolute terms. Moreover, when that deficit declines in absolute terms, it declines of course, much more rapidly relative to the GNP and relative to what is very important, the domestic savings in the economy.

As you know from my prior testimony, one of the elements of the budget situation that has worried me most is that deficits have been so high that the interest bill on the debt is growing so fast that it creates a problem reducing the deficit. In other words, the problem has been feeding on itself.

Our projection of the impact of this resolution assuming that it be fully implemented, and given our forecasts of interest rates, is that the interest bill would be stabilized relative to our national income. Furthermore, that simply reflects the fact that the debt-to-GNP ratio would start to go downward after 1987. Figure 2 on page 16 of my testimony makes that very important point.

The **Chairman**. Based on what you have said here as well as in your written testimony, going back to 1982 with recovery beginning, CBO forecasts about 2.6 percent growth in real GNP in 1985, roughly 3.5 percent per year over 1986 to 1990 period.

My concern, Dr. Penner, quite candidly, is what the factors are that lead you to believe that there will be such an extraordinary recovery, which would really mean 8 years of steady economic growth, nearly twice as long as the postwar average.

What are those factors that lead you to believe that we are going to have 8 years of economic growth?

Mr. **Penner**. That is a point that is very often misunderstood in our projections, Mr. Chairman, probably for good reason. Maybe we are not clear enough about it. We distinguish our forecast period, which in this case goes to the end of 1986, from our longer term projections, which obviously have to be much cruder and which depend largely on economic history.

We do think that the probability of a recession by the end of 1986 is very low indeed. One of the major reasons for our belief is what has happened to interest rates recently, as well as what has happened to the dollar. These developments reflect in part a very expansive monetary policy. So it is indeed a forecast of ours that there be no recession before the end of 1986.

In my more complete testimony, I have suggested what would happen if there is a very severe recession. In that case, the deficit would go way up to around $270 billion, but that is not our forecast. That would be in the case of an extreme recession.

After 1986, as I said, we depend on historical experience there, and those numbers you see are an average really of six postwar periods. They are overlapping periods, but they are six postwar periods, five of which have had a recession in them. By averaging them over time, we are in fact implying that our average growth rate is consistent with a mild recession in that period.

It would have to be mild admittedly. Or, putting it the other way around, if I truly believed we would not have any recession at all before the end of 1990, I could have rationalized a higher growth rate in that period.

We smooth it out that far in advance because it would be silly of us to argue that we knew precisely when it was going to start and precisely when it was going to end. That longrun path, however, does not absolutely rule out recession.

It does rule out a very severe recession. If we had something like the one in 1974–75, the path would not be viable, but some mild recession is possibly consistent with that path.

The **Chairman.** I am glad for that clarification. What you are saying is that you predict growth to average that amount over the period, but that doesn't mean that we are not going to have a recession.

It does have allowances in that average for a mild recession. Could you give me two more responses, Dr. Penner? What happens if we have a recession, particularly in terms of the deficits? Could you give us a quick viewpoint on what happens in a mild recession, what happens in a deep recession, and second, that leads me to the last question that I am going to ask and I will pass it on to my other colleagues. Would you also comment on the Gramm-Rudman approach to the deficit question, particularly if we have a 1987 recession of the size in the CBO low-growth path? As I understand it, based on what I know as the Gramm-Rudman approach, it would mean that in 1988 we understand the formula of Gramm-Rudman would be faced with cutting $164 billion in spending, just as you are coming out of a recession in 1987. Could you comment on the implication of that for the economy, the Gramm-Rudman approach, vis-a-vis the low path that you have put into your projections?

Mr. **Penner.** First of all let me go to your first question. Our low-growth path, which is described in table 7 on page 21, of my complete testimony, does assume not only a recession but a very severe one starting in 1986. Indeed, the path we simulated there replicated to the extent possible the 1974–75 experience, and that peak to trough was the worst recession we had experienced since World War II. Thus, we regard that as an extreme.

I should make that point very clearly. We think there is a very low probability of doing worse than our low path or better than the high path. But in any case, given that extreme view, we have very precisely computed the budget implications. If you look at the bottom row of table 7, you see that the deficit peaks at $272 billion in 1988, and then comes down very slightly after that. Obviously, a deficit that high leaves us in the situation that I hope this budget resolution will avoid. That would be a situation in which the deficits are so high that the interest bill on the debt is part of a problem that makes it difficult to figure a way out of the whole.

We have not done such precise simulations for milder recessions. Obviously, the results would not be very severe in that case. With regard to the implications of Gramm-Rudman for all of this, first I probably should note that there has been apparently some change in the bill in terms of how it handles recession. Whereas previously you would be exempt from that bill if CBO and OMB forecast a negative year-over-year growth, it is my understanding that now we are supposed to forecast quarter-by-quarter, so that any two successive quarters of negative growth would be equivalent to the declaration of a recession and an exemption from the provisions of Gramm-Latta. Excuse me, I mean Gramm-Rudman. Excuse me, Mr. Latta.

The **Chairman**. We constantly have this. When people look at Mr. Latta here, they automatically say Gramm-Latta, and Mr. Rudman just gets dropped.

Mr. **Penner**. I should really say Gramm-Rudman-Hollings, and I apologize to Senator Hollings as well. In any case, that changes the situation. If we were truly in the situation that you describe, which we would regard as a very surprising development—that is to say, a big recession and fairly sluggish recovery from that recession—then the requirements of the amendment would be very severe indeed.

I do think it has to be remembered that these are legislative targets, so that if there is an overwhelming consensus that they lead to some surprising and generally believed to be undesirable result, they can be changed.

The **Chairman**. Thank you, Dr. Penner.

At this time the Chair will yield to the ranking minority member, Mr. Latta.

Mr. **Latta**. Thank you very much, Mr. Chairman.

Thank you very much, Dr. Penner, for your testimony. Let me pick up just where you left off about changing the Gramm-Rudman-Hollings approach. I think that this is something that is being overlooked. This would be a statute, and as you well know, they have waived the Budget Act many, many times since it was enacted. So certainly if you got into a period of a deep recession, notwithstanding what they might have done last night and will do today in the amending process, this Congress or the next Congress could waive this act and it would become law. Is that what you are saying?

Mr. **Penner**. Yes, it is in the form of legislation, so it could be amended at any time.

Mr. **Latta**. Let me also pick up what you said about the possibilities of a recession in the latter part of 1986. I heard you say the first time that the possibilities of a recession for the latter part of 1986 were low indeed, to use your statement. Is that an accurate assessment of what you said?

Mr. **Penner**. That is correct, yes.

Mr. **Latta**. Your projections on page 10, estimate real GNP growth at an average of 3.5-percent rate, which is about what we have now, unemployment rate declines gradually to 6.3 percent by

1990, and inflation holds at about 4.2 percent, close to the current levels. Interest rates remain flat at 7.2 percent for Treasury rates and 10.2 percent for corporate bond rates. That sounds to me like that is pretty steady as you go, so to speak, for that period of time.

I have to come back to the question that was raised by the chairman about this growth that we have had, and the factors. Don't we have to take into consideration the fact that we did have a tax reduction that is still in effect, that has stimulated this growth?

Mr. PENNER. There have been any number of things, sir. Once we get beyond 1986, we rely on history very heavily in making those forecasts. They need not be precisely consistent with an extrapolation of policy, whether it be tax policy or spending policy. In the most general of terms, I think things add up all right, but it obviously gets harder and harder to do those sorts of things the farther out you get.

Mr. LATTA. Let us go back and try to get an answer to that question another way. Would we have the growth that we have had, and would we see in the future the growth that we expect, had we not had some tax reductions to stimulate the economy?

Mr. PENNER. In our analysis of the situation, the main effects of the tax changes in recent times have been really very large changes governing investment. We believe that those changes played a significant role in the increase in investment, the really strong investment boom, at least in gross terms, that we had during 1984. Indeed, looking at it further, or perhaps putting it another way, it is always complicated to hold just one thing constant. But I think if we had the kind of real interest rates we had in 1984 without those tax incentives to investment, we would have had some problems.

In other words, the tax changes did bear some responsibility for the investment boom in our analysis. That wears off over time. Obviously, if you change it you get a big surge; then when the businesses reach their new equilibrium level, that impact tends to decline.

Mr. LATTA. One final question. As you know, the Ways and Means Committee is now in the process of marking up another tax bill. I was wondering whether or not you had taken into consideration the prospects for passage of this legislation in your projections?

Mr. PENNER. No, sir, we never try to forecast legislation. The shortrun forecast in particular assumes current law in all respects.

Mr. LATTA. Thank you very much.

The CHAIRMAN. The Chair recognizes the gentleman from Michigan, Mr. Wolpe.

Mr. WOLPE. Thank you very much, Mr. Chairman.

I would like to pursue for a moment the question that was raised by my distinguished colleague from Ohio on the relationship between the tax cuts and the flow of investments that have occurred in this country. Could you tell us if you were to go back to the 1980 projections of likely investment flows at that point in time, are you saying there has been more net investment taking place in this country since the tax cuts than there would have been without those tax cuts, Dr. Penner?

Mr. **Penner**. Yes; I am suggesting that the tax cuts were beneficial to investment in the sense that I think more was undertaken than would have been otherwise, which is a slightly different question.

Mr. **Wolpe**. Yes.

Mr. **Penner**. I am comparing it with the forecasts of 1980, simply because such a great variety of other things went on—the disappearance of inflation, the changes in monetary policy, and so on.

Mr. **Wolpe**. There are some of us who believe that the tax cuts, among other things, have had something to do with the sudden jump in the magnitude of Federal deficits, and that those deficits, in turn, have had something to do with the recession and other indicators of recent economic distress we have experienced. Indeed, for at least 2 or 3 years following the tax cuts, we had less investment taking place in this country than we had previously, and the cumulative investment that has occurred in the past 5 years is less than had occurred in the previous 5 years. Is that not accurate?

Mr. **Penner**. I would have to check that carefully. It depends on whether you look at gross investment relative to GNP or net investment. I can reply for the record on that issue and compare those 5-year periods. But I think the point is, yes, all sorts of other things went on—the wringing of inflation out of the economy with a very tight monetary policy, which drove the economy downward, as you indicated; also, effects of the deficit itself on the interest rate structure, and in particular on real interest rates.

In answering Mr. Latta, I was trying to point out that because you get such a focus on particular kinds of investments by the tax rate changes, and because of the way we do the arithmetic in looking at investment incentives, those were very crudely speaking sufficient to counteract the increase in real interest rates that also occurred over that period, though not sufficient to counteract everything else that happened.

Mr. **Wolpe**. That is right. It seems to me that that is in a very perjorative sense a terribly academic response. I mean, the issue is the impact of the tax rates upon the overall investment picture in this country. To suggest that the tax cuts stimulated investment that would not otherwise have taken place without referencing the impact the tax cuts had upon deficit creation and all of the recessionary conditions is really to engage in an extraordinary kind of ivory tower response. I know that is harsh language, but I find it an extraordinary response that you just made.

Mr. **Penner**. You may be making a fine distinction that I am missing here. I think it would be hard, given what happened, to blame the recession on the deficit as it evolved. I think what was happening was much more related to monetary policy responding to the previous inflation, so there was a very tight monetary policy, which was important too.

Mr. **Wolpe**. Let me say I didn't mean to suggest that the deficit was the only factor—I am saying it was one factor. I am saying the tax cuts did other things besides help investments. There is a whole series of other conditions that clearly flow from the tax cuts. Is that not so?

Mr. **Penner**. It is certainly true, but I would then go beyond the business tax cuts, to the personal tax cuts as well. The point is that a lot of very dramatic things happened over that period from 1980 to the current time, in policy quite different than tax policy, so I was just trying not even isolate the impacts of all tax policy in my answer, but just that very narrow aspect.

Mr. WOLPE. I understand. I just don't want to leave the impression that somehow the tax cuts were responsible for a net increase in investment activity that would not otherwise have taken place. I think the data would demonstrate that there was a decline in investment for some period of time.

Mr. PENNER. True.

Mr. WOLPE. And that to the extent that the decline was attributable to high deficits and recession—some of which was attributable to the tax cuts themselves—it is hard to argue that the tax cuts were, on balance, a positive force for investment in this country.

Mr. PENNER. I am probably not giving you the answer that you want, but it is a fact that after the tax cuts, the gross investment soared during the economic recovery. Now, there were all sorts of other things going on. There was——

Mr. WOLPE. The economic recovery is a terribly important qualifying phrase. We had a few things that happened before the economic recovery, did we not?

Mr. PENNER. Yes, but historically they went to very high levels. There were technological changes. There were all sorts of things going on. I mean you are right. It is very hard to isolate one particular variable. But the tax cuts were very beneficial to investment, and we do think that had some effect.

Mr. WOLPE. Let me ask you if I may also, to return to a subject the chairman raised earlier, namely the question of how to structure a mechanism within the budget process that will assist the economy in a recessionary period.

Could you provide whatever counsel you can with respect to how you would structure such a recessionary mechanism if you were to try to put this together in terms of what is now being attempted within the Gramm-Rudman-Hollings initiative, or proposals we are examining in the Congress? What formula would you advance as a means of insuring sufficient flexibility? If you were actually structuring the proposal how would you do that?

Mr. PENNER. I think that here again one has to differentiate the academic from the practical. First, I think the important point is that the law puts a rigid formula into effect and, while one can tinker with that formula in all sorts of ways to try and make it responsive to contingencies, as long as the formula is set in concrete, all sorts of surprising things can happen. In those circumstances, I wouldn't want to have your exception of not changing the law.

I think conceivably if we get shocked, we could, of course, alter the targets, but beyond that there are technical sorts of things, and I am not sure that we would have any political appeal at all. One could put the focus on the deficit adjusted for cyclical factors, for example. The problem with that is to calculate it you have to make all sorts of technical assumptions that are not very appealing to the public, and you leave a lot of power in the hands of technicians, which the bill does in any case.

What I am really saying is that I think it is hard to make complicated technical changes that can be easily explained and that would have any political appeal.

Mr. **Wolpe**. You would resist an automatic triggering of additional cuts if one were coming out of the recession, coming out of that recessionary series of quarters?

Mr. **Penner**. It depends so much on the circumstances that you would face. There would be circumstances where the cuts would not be very severe and could easily be offset by monetary policy, for example, but that would depend on how much flexibility you had in monetary policy because of other factors—the dollar or whatever. Sometimes you might want to do that; sometimes you might not. It is hard to generalize about these matters.

Mr. **Wolpe**. I agree with that. But I want to emphasize the notion that somehow we can change a law. In this institution it is not always as easy as you may have observed recently. It takes only one-third plus one Member of either body to stop that process from going forward. You have to assume the ability to override a Presidential veto. I think it is important we understand that as we go about this process now of crafting a new law. Thank you very much.

The **Chairman**. Thank you. The gentleman from Kansas, Mr. Slattery.

Mr. **Slattery**. Thank you, Mr. Chairman.

Dr. Penner, I am just wondering, I am looking at figure 2 in your testimony today, and as I look at that figure, I can see that the Federal debt held by the public as a percentage of gross national product was about 60 percent in 1955, and then was on a steady downward path to about 41-42 percent, approximately where it is today, by 1964 say, somewhere in that timeframe.

Tell me, sort of playing the devil's advocate a little bit on this issue, we are at this point right now and following 1964. With the Kennedy tax cuts at that time, Kennedy-Johnson tax cuts, we stimulated a period of enormous growth that lasted for the better part of 6 or 7 years, and during that period of time the Federal debt as a percentage of gross national product dropped precipitously until about 1974, for almost a decade.

Looking at this, why can't we anticipate or put in place policies now that would basically put us on a growth pattern, too? Is there anything intrinsic about having a debt that is equal to 40 percent of gross national product that is basically antigrowth policy, you might say, as some would have us believe?

Mr. **Penner**. I think there is and I can respond to your question at different levels. We believe very strongly that additions to the debt do have an impact either on the rate of capital formation in this country or on the amount of capital in-flows into this country, which of course would have to be paid for in the future.

So, I think as a general rule, in terms of future standards of living, of the American people, that less is better and there have been a lot of empirical studies—as controversial as they have been—that suggest substitution of public debt for private debt.

I think it goes further. It would be misleading to compare the debt levels in 1964 with those today, even though they are roughly the same, as you point out. The point is that back in 1964, we were in an era where budget deficits had been very low. In the sense of relative to GNP at least, we had been paying off, if I can use that term, though it is not exactly precise. We had been paying off the debt accumulated during World War II, however, and the tax cuts of that time took place with a starting point of a budget that was in very good shape in terms of the deficit implications.

In other words, there was a whole aura, if you like, which I think was beneficial to expectations that we were going to keep lowering this debt to GNP ratio.

Since 1974, that aura has not existed. The debt stopped declining at that point relative to GNP, and I think you might argue we went into a different fiscal regime where deficit reduction was given much less priority in the way we looked at the world as a nation. As a result, as you can see from the chart, the process continued and accelerated, so that now we start without any presumption that that ratio will be decreased.

What is even worse, you might say we start with a presumption that it will continue to increase, and I think that creates a very different expectational environment for investment and for inflation as well. If this thing really got away from us—and I think there is a low probability of that now—but if it really did get away from us, the pressures to dig our way out of this hole by inflation would be very strong indeed.

Mr. **Slattery**. Are you suggesting that the principal difference, historical perspective between what we had in 1964, when in fact we had a Federal debt held by the public ratio of GNP equal to what we have now, that it gives just in expectations, is that what you are talking about?

Mr. **Penner**. Well, I am saying——

Mr. **Slattery**. Principal difference?

Mr. **Penner**. Yes sir, I am saying that was a very important difference, and that difference in expectations was very much influenced by the fact that we had this strong downward trend as opposed to now, when we have been on a strong upward trend. We benefited from other things in that era as well. We were able to stimulate the economy vigorously both monetarily and fiscally in that era because we had so squeezed the long-term inflationary expectations out of the economy in the 1950's.

People just didn't expect the increases in demand to lead to inflation in those periods even once we had our spate of inflation with the Vietnam budgets of the late sixties and early seventies, it was strongly believed that that was a very temporary situation. Indeed we imposed wage-price controls with a level of inflation that was little different than today's, which we think is wonderful today. It was thought to be horrible then. It was a very different kind of era and none of us knew at that time that we were about to enter into the most inflationary period on a sustained basis, in this Nation's history. So I am just saying there were all sorts of things that I think gave us more flexibility in the 1960's than we have today.

Mr. **Slattery**. Let me ask you something else. You hear a lot of talk if we were to raise any kind of taxes, this would have the effect of short-circuiting the economic recovery. When we looted the economy in the neighborhood of $4 trillion—is there any validity to that argument to make a long story short? If you are talking about $10 billion coming out of the economy, in the neighborhood of $4 trillion, can a $10 billion annual tax increase reek havoc on economic recovery?

Mr. **Penner**. I think the most crucial point in answering your question, whether it be $10 billion, or $20 billion or $30 billion, is what kind of tax increase. You can have terribly inefficient tax increases, and you can have increases that might improve economic efficiency in terms of doing away with some egregious tax shelters and so on.

As a general rule, I think all economists would agree that an increase, some sort of average across-the-board increase, would have some impact on economic efficiency. There would, however, be somewhat less agreement as to its impact on aggregate demand.

I think the more important point, though, is to really look at the big picture here. What we really have to decide, which is a political value judgment that you all have to make, is what do we want Government to do and who should pay for it. In answering that question, we are always making tradeoffs between economic efficiency in the private sector and what we think Government should and should not do. The biggest—and I suppose the most important political argument we have as a society—is just where we should be on that tradeoff.

That is absolutely, I think, in general terms, the largest issue we face, leaving aside the exception of our tax system being so bad that there are a few places you could actually raise taxes and improve efficiency. I don't mean there are a lot of places like that. As a general rule, we are always debating the tradeoff that I mentioned.

Mr. **Slattery**. Let me ask you specifically, for example, if you were talking about some kind of tax package that might include the continuation of the 16-cent tax on cigarettes and full basis adjustment on investment tax credit and minimum export tax, perhaps, and maybe a minimum tax on individuals. Would a tax package of this kind, where you would be talking about perhaps an increase of $10 billion in revenues in 1986–87—how can anyone say that that is going to have a devastating effect on the economy of this country? Does it make sense at all to make that sort of assertion?

Mr. **Penner**. You are talking about a very tiny tax increase relative to the size of the economy, even relative to the size of the deficit. I guess "devastating" is not a term I would apply to any of the effects of such an increase, but it is a continuum. I don't want to leave the impression that a tax increase wouldn't have some negative effect either. It is just in judging the effects that you have to look very carefully at the composition and ask yourself whether that negative effect is worth what you want to achieve.

Mr. **Slattery**. Another question I wanted to ask you, when you made your economic assumptions with respect to the growth of the GNP, what sectors of the economy are you projecting growth in, and what sectors of the economy are you projecting economic stagnation?

Mr. **Penner**. As I said in my testimony, the forecast rests very heavily on what has happened to interest rates over the last year. They have come down both nominally and in real terms quite substantially. Therefore, of course, we are expecting good performance in the most investment-intensive sectors. In housing in particular we are expecting real growth in investment.

As I also pointed out in my testimony that very recently, with this slowdown, the problem has not been so much a lack of demand in this economy, but a leakage of the demand into the international sector. Now, while we don't anticipate radical improvement we do, speaking very generally now, anticipate a halt to the deterioration, so removing that burden, that is because of what has happened to the dollar so far already, along with other things—so that's very important. That is to say, while we don't get a lot of boost from that, at least we don't continue to be buffetted by it.

By the way, that is in part related to what we see being accomplished on the budget deficit because we tend to view the trade and budget deficits as being Siamese twins. And referring to the second chart up there, we don't think it is any accident that they have moved together in the pronounced way that they have.

Mr. **Slattery**. What kind of growth do you anticipate for agriculture, a big part of our committee? I am curious when you blend it all together, the winners and losers. Assume in terms of your projects—I am just curious what you project for agriculture, what you project for steel, autos, the basic industrial base of the country. Is that the way you do your projections on a sector-by-sector analysis, or how do you do them?

Mr. **Penner**. We do it in an iterative way. It is a judgmental forecast as opposed to depending on some big econometric model.

What we tend to do is add up sector by sector on the basis of what we know is going on there. But you might make your best guess about autos and agriculture and other sectors, and when you add it all up, you find that your addition does not satisfy other macroconstraints that have to be satisfied by the economy; savings has to equal investment. There is a certain nexus between productivity, labor force participation, and unemployment, and so on, that are definitional, that have to be satisfied. So if when we add it up at macrolevel, it doesn't satisfy those macrorestraints, we go back to the drawing board and say we must have made a mistake somewhere and shuffle things around. So it is a combination of a sort of down/up approach, then up/down approach, iterating to a solution which is logically consistent.

Unfortunately that doesn't mean it is right. To answer your question about agriculture, we are, I think, in general terms assuming some stabilization of prices there. We have had, as you well know, a very pronounced decline, and we see that situation stabilizing, which carried through to the inflation level is one of the reasons that we have the CPI going up a little more next year.

Mr. **Slattery**. I would enjoy questioning you further, Dr. Penner. I am advised I have a vote in another committee, so I am going to have to run off. I enjoyed visiting with you.

The **Chairman**. Thank you, Mr. Slattery.

Dr. Penner, let me pick up on a couple of other points. You talk about the fact that foreign capital is helping us deal with the debt situation. What happens when that foreign capital is no longer available?

Mr. **Penner**. We were very worried about that in the past, and I think the last time I testified before you I suggested that it was perhaps the largest risk facing us; that foreigners would, in some sense, lose confidence in us and decline to buy our assets any more, in which case you could have had a precipitous drop in the dollar, and that would in turn increase our inflation rate.

While at the moment we know that the Federal Reserve along with the Treasury, is engaged with other countries in trying to push down the dollar, obviously I think if it began to plummet they would reverse gears, as it were. There would be very strong pressures on them to try and stabilize themselves a little bit, which they can only do by raising interest rates, and which would have been raised anyway if the borrowings from abroad had dried up.

All of that would hurt our domestic capital formation, and indeed you could play out the scenario so that would end up in an outright recession.

As I said the last time I testified before you, I made that the No. 1 risk to our outlook. I think that risk has diminished somewhat, especially if we manage to go on that blue line as suggested by the budget resolution, as opposed to the red line suggested by an extension of current law.

So I think if you are a careful reader of my testimony, you will see that our assessment of the risk has changed somewhat, and we have raised others now compared with that risk.

The **Chairman**. But if that capital should dry up even with the blue line, we would still perhaps have some of those side effects that you mentioned: Inflation would go up, interest rates would go up. So, in a sense, it is the borrowing that is helping us get through this situation and gives us a false sense of security and feeling that everything is all right.

Mr. **Penner**. It has had very beneficial effects. As you well know, it has also had very negative effects in terms of hurting particular sectors of the economy as that very borrowing that has driven up the dollar made it difficult for exporters to compete and easier for other countries to import here. So it has had both effects. But you are right; the problem would be in trying to adjust to a real precipitous change.

The **Chairman**. So as I see it, in looking at the American public—you know, you have testified—that as a result of the deficit, strong dollar in the borrowing, we have a trade deficit of over $150 billion. People in my district don't quite relate to trade deficits per se. They also say, well, things look like they are going all right, but they know something is wrong because of the debt and deficit. They can't live that way and they wonder how we are living that way, and they know something is going to happen. And, essentially, we seem to be doing all right.

There are some who would say, well, this is not such a bad situation. I have heard people say that this is really not a bad situation—with the $200 billion deficit compared to the size of the economy and size of all of the spending. But the bottom line is that there are some real dangers, as you pointed out, that could affect all of us, despite the fact that we might be feeling pretty good right now. Would that be fairly accurate?

Mr. **Penner**. Yes.

Putting it another way, you can live well on borrowed money as long as people are willing to loan it to you. I think that is the basic point of your remarks.

The CHAIRMAN. In essence, that is exactly what we have been doing, living on borrowed money, policies of borrowing, and continuing to spend.

Mr. PENNER. Yes, sir.

The CHAIRMAN. And when we have to pick up the loss of revenues from the borrowing, it is going to have a radical impact on the economy.

Let me ask two more questions, and I will turn it over to the gentleman from Ohio.

It has been suggested by some that we can radically dry up the red ink simply by cuts in spending. Has your office looked at cuts in spending as an only way of reaching a balance? If you have, can you give us some idea of the size of cuts in spending that would move that blue line, as you have it there, that shows the work of this year's budget—has us going from over $200 billion by 1990, down close to $100 billion? What would it take to move that line on a much more radical course downward so that in 1990 you would have a balance simply by cuts in spending? And what would be the size of the cuts that would be needed?

Mr. PENNER. If I recall, in terms of options for doing that, the last time we published on that subject was in our budget reduction volume or deficit reduction volume, which we gave you last February. Some of those options are out of date because of what has been done since. But I think a very large number of them are still alive and well.

Looking at the numbers, in particular, it is always a little difficult to answer that question because very big changes in policy probably would affect the economy. But just for the sake of doing the arithmetic, right now let me assume that we could have the same economy through 1990, and our deficit projections for 1990 is, at the moment, $120 billion. That is on and off budget. And our extrapolation of outlays under the budget resolution for that year is roughly $1.2 trillion.

Looking at it proportionately, then, and remembering that you can't cut interest, it would be a little more than a 10-percent cut in all noninterest expenditures.

The CHAIRMAN. In other words, we would have to cut 10 percent of $1.2 trillion; is that what you are saying?

Mr. PENNER. Yes. I am speaking very crudely.

The CHAIRMAN. Roughly.

Mr. PENNER. Yes, sir.

The CHAIRMAN. So, in other words, we would have to cut $120 billion additional if we wanted to get potentially down to a balance in 1990?

Mr. PENNER. To zero. That is making a lot of assumptions, as you know.

The CHAIRMAN. Right; of course. That is based on a lot of assumptions which are not pinpointed right now.

One last question. In the Gramm-Rudman approach, as I understand it, of course it is being altered right now, who knows what the final version will look like, but there is something I am concerned about and that is that it would be CBO and OMB, some kind of joint venture that would determine when a recession came along, also whether or not we made or missed the targets.

Now, in light of what all of us know today was very unrealistic assumptions, really an inaccurate baseline, particularly in Pentagon spending, as you point out in your reestimate in August, do you have any idea how this marriage would work out between CBO and OMB where you would jointly come up with a criteria and tell us that we are going into a downturn, therefore, take in this escape hatch for the recession or how you all would work together in the marriage so that you would be able to say we have missed the target or said in Gramm-Rudman by *x* amount, particularly in the light of the fact there has been some significant disagreement between CBO and OMB over the years?

Mr. PENNER. Before answering your question, I would like to take one step back from the details of the marriage contract and look at the bigger picture. I think the extraordinary power that you would be conveying to nonelected officials in this amendment is a matter of some concern. I would certainly feel easier myself if there were some congressional endorsement of the actual forecasts that pulled the trigger as it were.

In terms of working with OMB to come out with an actual result, I guess that at the moment that doesn't concern me a great deal. As you know, the law says if there is a disagreement you add up the numbers and divide by two. There are some logical problems with that, but I guess that is not my main concern, Mr. Chairman.

In fact, our respective forecasts in terms of the levels of GNP, which are very important in this regard, have come a lot closer than they were a while back. So that the actual details of how we proceed don't bother me as much as the thought of proceeding at all.

The CHAIRMAN. Well, I have a deep concern because I know that OMB is a branch of the executive government, and I know the history of OMB assumptions and of course how political judgments are involved and thus any marriage situation where CBO on one hand would give one set of economic assumptions, all the executive branch would have to do, regardless of who was in office, is come up with another set of assumptions somewhere over there knowing that compromise is going to be somewhere in the middle.

Therefore, you can escalate the whole process and would have a very negative impact on the budget process as well as what we are trying to accomplish. So from my point of view, I say very candidly I would have a very difficult time supporting such a marriage.

I would prefer if something like that is to be implemented, I say if something, that CBO would have the determination as opposed to OMB because of the points that I have just read. However, I am glad to hear you point out as I agree with you, it does posit a great deal of decisionmaking power into a nonelected area, and maybe that is really what the intent of Gramm-Rudman is, to punt and give the ball to someone else and let them have the headaches.

Sometimes as chairman of this committee, I have often wanted to find someone else who could carry these headaches and deal with some of these burdens. Some of my colleagues point out that under Gramm-Rudman that actually besides OMB and perhaps

CBO, you are having an increased role in the budget process and priorities of this Nation, so would the Budget Committees of both Houses have an increased role and therefore if I had good sense I would be for an approach like this.

I always haven't been noted to have good sense, some of my critics would say I do have the concern that you have pointed out that besides the constitutional shifts that are implicit in the Gramm-Rudman approach, besides the economic problems, which you have commented on, that is where, on the one hand, you have a downturn in the economy, the target would be dropping away from you, Congress would continue to reach for that target, and it would not be because of spending; it would be because of a decrease in revenues.

You wouldn't be able to achieve it, even if the mechanism of recession was thrown into effect. Once you come out of the recession you would still be required to make significant reductions. Therefore, it leads me to believe there would be two things that would happen.

One, when you kicked back into the Gramm-Rudman targets, that you have disastrous effects upon the economy if you continued to pursue those same targets right after recession. Or, second, within 2 years the Gramm-Rudman legislation would be drastically amended so that what would be voted on would not be the same thing that would happen, let's say. In 1987 it would be tremendously altered because of the negative impacts upon the economy.

I am not asking you to respond. I would just make that statement. The gentleman from Ohio has the time.

Mr. Latta. Thank you, Mr. Chairman. A couple of questions back, the chairman was asking you about people living beyond their means and so forth. I think one of the things that we overlook in this whole picture about living beyond our means is the fact that the interest on the national debt keeps piling up as a debt. It is not a matter of being new current spending, you know, going beyond our means, but you have seen the interest on the national debt as a share of the budget go from just about 7 percent in the midseventies to between 15 and 16 percent of the budget this time. So that is something I think the American people do not realize and we do not bring it to their attention very frequently. As this debt piles up and the share of the total budget going for interest to pay for the national debt, we are going to be squeezing other programs more and more and more, and we have got to keep emphasizing that.

And although too often you say it's like the family budget, you have to live within your means and all that, even if we did that for 1 year that is not going to make the problem go away. We still have the debt out there we have to service.

Mr. Penner. Well, I as you know, from my earlier testimony before this committee, that was the single most important thing that I was worried about. I think in some ways even worse than you suggest in the following sense. Although a household may get itself into that fix where the interest bill on their debt runs away from it, countries don't often do that because countries have another choice. They can start financing government by printing money. That is in fact the situation in countries like Bolivia and

Israel where they are financing a very large part of their government by creating new money, mainly because they don't feel they can borrow any more because of the interest problem.

In that kind of situation, you move toward hyperinflation. I should add that we are a very long way from that right now with our current budget plan. But we projected such a situation 18 months before the downpayment on the deficit, before this budget resolution was passed. And under certain circumstances, if we have a lot of bad luck, we could be back into that kind of situation again.

Mr. **Latta**. What percent of our borrowing now is offshore?

Mr. **Penner**. Do you mean Government borrowing?

Mr. **Latta**. Right.

Mr. **Penner**. That is not very large. When OPEC was accumulating all of their oil surpluses, it was pretty high by today's standards. When we refer to us borrowing abroad to finance our deficit, we don't really mean directly in the sense of selling bonds to foreigners. We do some of that; I don't have the numbers with me, but we can easily get you the numbers on that.

The Government borrows from domestic savers and that squeezes up interest rates and that attracts foreign investment into private investments here, which was perhaps not the most important thing that has gone on quantitatively. Actually, the most important thing going on quantitatively was really not even foreign investors moving their money here so much as Americans who would have otherwise invested abroad keeping their money here at home to take advantage of these high interest rates.

Mr. **Latta**. One final question on Gramm-Rudman-Hollings. If this becomes law without real substantive change, say, we have to trigger this reduction across the board, and some particular agency or department has taken the bull by the horns so to speak and sunset or eliminated programs, won't they share unequally in the reduction if you take it across the board? Wouldn't it be penalizing them for doing something rather than applauding them?

I could point out several programs that I would have sunset yesterday, but I won't do that. I wonder how we are going to compensate in this whole scheme of things for these departments who do things like that, just assuming they might? I haven't seen too many of these programs sunset since I have been around here.

Mr. **Penner**. As you point out, they have been making technical changes in the law, so I am not sure what I am going to say is right, but at one point it was my understanding that it was structured so that programs could not be eliminated, they could be cut across the board.

Mr. **Latta**. Excuse me, that is not what I had reference to. That is after the fact. I am talking about in the general scheme of things as we go through the legislative procedures here in the Congress, that say department X realizes that we have the budget problem and for the last time they say, we are going to sunset X program and X program and they do it, and the Congress goes along with it, are they going to share unevenly in, or are they going to get credit?

Mr. **Penner**. Well——

Mr. **Latta**. For sunsetting *x* numbers of dollars?

Mr. **Penner**. I am sorry. I did misunderstand you. As I understand how this would work, there would be no credit for past good behavior or any penalty for past bad behavior. It would go into effect with whatever levels you happen to have at the time.

Mr. **Latta**. That is something, if that is the way it is right now, that I frankly think is going to have to be looked at, because there would be no encouragement for these departments and agencies to get rid of some of the programs that they should get rid of. Thank you, Mr. Chairman.

The **Chairman**. Thank you, Mr. Latta.

At this time the Chair wishes to thank Dr. Penner for being with us. What we plan to do is recess for 20 minutes, until 11 o'clock when our next witnesses will join us.

Believe it or not, we are running ahead of schedule. At that time we will have Dr. Behravesh, Dr. Chimerine, and Dr. Sinai, who will be appearing before us from Shearson-Lehman, Chase Econometrics, and Wharton Econometric Forecasting Associates.

The committee will stand in recess.

[After recess.]

The **Chairman**. The committee will come to order. We will resume our hearing on the crucial topic of deficits as well as the national debt and the economic budget outlook and impacts on those in the future. Joining us now is a panel of three distinguished economic forecasters, Nariman Behravesh of Wharton; Lawrence Chimerine of Chase; and Allen Sinai of Shearson-Lehman.

Gentlemen, we want to welcome you to the House Budget Committee hearing with regard to what I consider is one of the most pressing problems that we face. Each of you brings a wealth of information and knowledge. Mr. Chimerine is chair and chief economist for Chase Econometrics, and as such supervises the U.S. economic forecasting in macroeconomical analysis and has testified frequently before congressional committees. He has a Ph.D. in economics from Brown University and was manager of U.S. Forecasting for IBM Corp. from 1965 to 1979.

Mr. Behravesh is vice president of U.S. Services for Wharton Econometrics, and he comes to us with a similar outstanding background. A Ph.D. in economics from the University of Pennsylvania, which I have some pride in, since a part of it is in the Second Congressional District, and since my father also attended the University of Pennsylvania, he has the responsibility for all of Wharton's U.S. forecasting and analysis operations, including providing budgetary assumptions for the macroeconomic forecast.

And also Dr. Sinai, who has been the chief economist and managing director at Shearson-Lehman since 1984, and prior to this he was vice president and senior economist at Data Resources, Inc., with responsibility for financial modeling and forecasting. He holds a doctoral degree in economics from Northwestern University, and has also distinguished himself as a professor at Massachusetts Institute of Technology and Boston University.

Gentlemen, we welcome you to the House Budget Committee and ask you to perhaps summarize your written testimony. Your full testimony will go into the record as you have presented it. We hope that you will be able to summarize the essence of your positions and your concerns in 5 to 7 minutes, so that we can have more time for questioning.

At this time we will call on Mr. Chimerine, chair and chief economist of Chase Econometrics, to begin.

STATEMENT OF LAWRENCE CHIMERINE, PH.D., CHAIRMAN AND CHIEF ECONOMIST, CHASE ECONOMETRICS

Mr. **Chimerine**. Thank you, Mr. Chairman, I would like to remind the chairman that we, too, are based in the Philadelphia area. I think you are already aware of that, but this is just a friendly reminder.

The **Chairman**. Welcome again.

Mr. **Chimerine**. I understand that my prepared statement has arrived. It is quite lengthy. I ask that it be put in the record, and what I will try to do now is to summarize it very briefly.

I would like to focus on three areas. No. 1 is the current short-term economic outlook as we see it. Second is the budget outlook. And third is my recommendations on how we can deal with some of the current problems, particularly the budget deficit, and if we have time, on the trade issue as well.

Let me start with the current economic situation. I think you are aware, Mr. Chairman, of the dramatic slowdown that has taken place in the U.S. economy during the last 15 months or so, following a very buoyant recovery earlier. During these past 15 months we have experienced very slow and erratic growth. This is not only a dramatic slowdown from the first year and a half of the recovery but economic growth in the last 15 months has even been well below the long-term average.

To me it is quite disturbing, because even though we recovered fairly strongly in 1983 and the first half of 1984, by no means had the economy reached a healthy and prosperous condition at that time, partially because we started the recovery from such a depressed level of economic conditions. Eighteen months of healthy growth coming from a depressed level doesn't return the economy to full health. So we need much stronger growth than we have been getting, and we have not gotten that strong growth over the past 15 months.

In my judgment, there are essentially three reasons for the slowdown. One is that there were a number of temporary factors that pushed the economy up fairly rapidly in 1983 and early 1984, but the effects of these factors was bound to peter out. These include inventory rebuilding, the extremely accommodative monetary posture, and the impact of investment incentive on the growth in investment spending. So even under the best of conditions, as the impact of these factors petered out over time, we were bound to get slower economic growth than we had earlier.

What is very disturbing is the extent of the slowdown, and as I said a minute ago, economic growth has averaged only about 2 percent for the last 15 months, which is extremely disappointing.

The first of the other two factors that I think are responsible for the extent of this slowdown is interest rates. Despite some declines in interest rates, they remain extremely high in real terms, particularly for industrial companies that are considering either inventory or capital spending decisions. When you consider that there is virtually no inflation in the industrial sector, and nobody thinks they can raise prices during the next several years, current real interest rates are still quite high and prohibitive, particularly at this point in the recovery.

Many companies have already funded their highest rate-of-return projects, and many people have made their most necessary expenditures. As a result, at this stage in the recovery, we need lower interest rates than we have been getting, and that has been one of the factors limiting economic growth.

The last factor is the dollar. I know you are keenly aware of the devastation that is being caused by the overvalued dollar. Import penetration is spreading throughout the United States at an incredible rate. It is not just in steel and shoes and a few other industries—it is occurring in just about every manufacturing industry. Exports remain very weak, and we are also experiencing a profit squeeze in the United States.

All three are in great degree the result of the overvalued dollar, and obviously these are limiting economic growth as well. So I think the two factors which have become the key factors limiting the recovery are high interest rates and the overvalued dollar—in turn, they reflect large and rising structural budget deficits. We have now thus begun to see the negative impact of those deficits on the economy, and in my judgment unless we change the deficit pattern, we are likely to continue to see these adverse effects, which will limit economic growth in the years ahead.

As for the near-term outlook there has been some optimism expressed, partly reflecting the strong growth in the money supply during the last year, and partly reflecting some recent statistics. Some are arguing that the economy is now in the early stages of a significant acceleration, and there are many people, quite frankly, including the administration, who as of a few months ago were talking about a second economic boom, between now and the end of 1986. I have a hard time understanding the logic behind those forecasts.

First of all, the money supply is overstating the likely impact of money growth on the economy, because to some extent the sharp growth in M1 simply reflects technical factors financial market deregulation. Second, interest rates remain quite high, and third, the underlying fundamentals in the economy do not support rapid economic growth, since they to a great extent are offsetting the impact of easier money.

I am talking particularly about the sharp decline in income growth we have experienced, and accompanying that, the low saving rate. Some of the saving rate reflects the fact that we have not yet seen the full impact of import penetration on consumer spending, because spending for imports does not generate an equivalent amount of income in the United States, and as a result income growth has slowed.

Eventually that has to cause spending to weaken. We haven't yet seen the full impact of that. In addition, mortgage standards are being tightened throughout the United States, which offsets some of the benefits of lower mortgage rates. We also have very high vacancy rates throughout the construction sector. And capacity utilization is both low and falling, which is beginning to hurt capital spending. No company I am aware of is interested right now in rebuilding inventories, and I think the outlook for the trade deficit is still horrendous.

When you put all these factors together, it is going to be extremely difficult to have sustained strong growth over the next year and a half. We may get it for one or two quarters, but on average, rapid growth is highly unlikely during this period. The best we can hope for is a continuation of the 2 or 2½ percentage average rate of growth we have already now for the last five quarters.

Without going into detail, the recent statistics are also generally very misleading—they overstate the strength in the economy because they reflect temporary strength in automobile sales because of low interest rate promotions and a number of other temporary factors which overstate the strength of the economy.

The feedback from our clients across a broad spectrum of the economy indicate that at best, all they are seeing is a marginal improvement in their business. At best, the economy is picking up a little bit, and there is no evidence to support a 5 percent real growth scenario, such as the administration has submitted.

Let me spend a minute or two, Mr. Chairman, on the budget outlook. I heard Rudy Penner this morning talk about the current CBO projections. I have a very strong disagreement. In my judgment, the likelihood that we will see deficits reduced to the levels implicit in CBO's calculations is very, very low. My best guess is the best we can expect is that the deficit will be stabilized at $200 billion a year for the next 4 or 5 years, even taking the budget resolution into account.

I think that both CBO and OMB are enormously optimistic in terms of sustainable long-term economic growth.

Second, a lot of the so-called budget cuts implicit in the budget resolution are not going to materialize, particularly in the agricultural area and some other areas as well. So, again, I think a realistic assessment is we are in for $200 billion deficits each year, unless new actions are taken.

That is an improvement, but it is not enough of an improvement, because in my judgment, Mr. Chairman, the objective of budget proposals now should be to implement a program which causes the Federal debt-to-GNP ratio to decline in the years ahead. The fundamental problem is the debt, not the deficit.

Obviously they are interrelated because it is the rising deficit that is causing the debt to rise, but we have to approach what we want the deficit to be based on where we want the national debt to be. We have got to put the debt-to-GNP ratio on a downward trend in the years ahead, to prevent continued reliance on foreign inflows of capital, or prevent the need for potential inflationary monetary policy, or prevent squeezing out the rest of the economy from credit markets. The only way to achieve that is to cut the Federal debt-to-GNP ratio.

To do this, it is essential we reduce the deficit to about $50 billion by 1990, or roughly speaking, $25 to $30 billion a year each year from current levels.

I think the objective of Gramm-Rudman, therefore, is probably desirable. However, I am not particularly thrilled with the legislation, for reasons I will mention, but I think the idea is right. We do want a gradual decline in deficits, getting close to a balanced budget by early in the next decade, but there are several problems with the legislation.

First of all, there are not adequate safeguards against recession. There will be some years we don't want to cut the deficit by $30 billion from the year before. In others we may want to do more. This legislation is too rigid in my judgment.

Second, I don't understand why we are not including Social Security, because I think some of the areas that should be cut include the Social Security program by moving more toward making it a means-tested program. Thus, you would cut benefits for those people with either high income or high wealth, and I think putting it in this legislation will remove that possibility.

Third, as you well know, the administration has had a way of showing reduced deficits in recent years by using very optimistic economic forecasts, and I can envision a scenario a year from now where the same thing happens. The economy won't perform that well. Then the President will, as a result of this legislation, make very sizable and severe cuts in various programs. And you are limited on which programs you will cut, particularly if Social Security is off the table and with all the defense contracts out, and we would probably be cutting the wrong programs. And of course there is the question of how much power the President will be getting to make these cuts, relative to the Congress. In my judgment, therefore, I think the particular legislation has a number of problems.

My own suggestions would be to put a program in place now, with specific spending cuts phased in over the next 5 years, aimed heavily at the entitlement programs—particularly the health and pension programs—by making them more means tested programs, and second, by admitting the fact we are going to need more tax revenues. Anybody—this is not a political statement, Mr. Chairman, it is simple arithmetic—anybody who takes the trouble to look at the numbers will have to admit we are going to need some more revenues. I would do it in a way that combines it with tax reform, by instead of reducing rates to 5, 25, 35, we should go to 17, 27, 37. We will still broaden the tax base and lower marginal tax rates, but do it in a way that will raise some additional revenue. When combined with a program to make additional spending cuts this will achieve the deficit pattern we need for the years ahead.

I might add, if we do it that way, we will be raising most of the revenues from the people who are now not paying their fair share. We can do it in a way that it doesn't make the distribution of the tax burden even more regressive than we have already done, and at the same time take a big step toward reducing future budget deficits.

Thank you, Mr. Chairman.

[Testimony resumes on p. 74.]

[The prepared statement of Mr. Chimerine follows:]

PREPARED STATEMENT OF LAWRENCE CHIMERINE

My name is Lawrence Chimerine, Chairman and Chief Economist of Chase Econometrics. I appreciate this opportunity to testify before the House Budget Committee on the Economic and Budget Outlook, and to present my recommendations on Economic and Trade Policy.

Summary

In sum, my views are as follows:

(1) The U.S. economy has experienced relatively slow and erratic growth since the early summer months of 1984. This represents a sharp slowdown from the first year and a half of the recovery.

(2) Several recent statistics which appear to suggest that a sharp acceleration in economic growth is now underway overstate the strength in the economy -- at best, only a modest pickup in economic growth is now taking place.

(3) Strong growth in the money supply during the last ten months has also generated hopes for a new economic boom. However, the growth in the basic money supply (M1) overstates the degree of stimulus because it partially reflects changes which have resulted from financial market deregulation and other factors, rather than increases in transaction balances.

(4) Other underlying factors also suggest that, while a recession is not likely between now and the end of 1986, sustained very strong growth is equally unlikely. These include continued relatively high real interest rates, the still highly overvalued U.S. dollar, slow growth in household income and an extremely low saving rate, weak profits, and high and rising excess capacity in the industrial sector and most segments of construction. On the other hand, declining oil prices and generally low inflation, the absence of a substantial inventory overhang, rising military expenditures, and increases in cash flow resulting from rising depreciation allowances, will bolster economic activity. The net impact will be slow growth on average, with several major downward risks.

(5) Despite enactment of the recent budget resolution, the outlook for the Federal budget remains poor. I expect that unless new stronger actions are taken, deficits will remain close to $200 billion per year to the end of the decade. Recent deficit projections by the Administration and the Congressional Budget Office are more optimistic; however, in my judgment they are

based on unrealistic economic assumptions and include more spending cuts than are likely to take place.

(6) This continued bleak outlook for the Federal deficit will also limit economic growth during the period ahead, since interest rates and a rising dollar will likely accompany any meaningful pickup in the economy until the deficit is reduced. Such increases in rates and the dollar will only slow the recovery process again shortly thereafter.

(7) Current Administration and Congressional forecasts of economic growth averaging 4% overstate potential growth based on expected productivity, labor force and investment trends. A more realistic expectation would be in the range of 3% to 3.25% per year. Furthermore, unless current economic policies are adjusted, it is unlikely that even 3% average growth on a long-term basis will be achieved.

(8) Significant reductions in future budget deficits would enable the economy to perform closer to potential because of significantly reduced pressure on interest rates and the U.S. dollar. I believe that it is essential to reduce the deficits on a year-by-year basis by approximately $25 to $30 billion (if economic conditions permit), thus producing a budget deficit in the $50 to $75 billion range by the end of the decade. To accomplish this objective, measures to reduce the growth in entitlement programs as well as some modest tax increases will be necessary.

(9) I believe that tax increases which are necessary to reduce future deficits should not reduce incentives for investment, should be targeted primarily toward those who are not now paying their fair share, and should not make the distribution of income and the tax burden less unequal than it now is. The best way to raise revenues and achieve these objectives is to combine tax reform with deficit reduction.

(10) In order to improve near-term economic performance, some specific trade measures may also be needed. These would include measures designed to offset trade related hardships, as well as to make trade more fair on a worldwide basis. In addition, temporary relief from the overvalued dollar might be necessary -- this can be accomplished by taxing foreign-held U.S. assets in order to drive the dollar down more quickly, or by implementing a floating tariff and export rebate based on the degree of dollar overvaluation.

Recent Economic Performance

After the extremely strong growth experienced during the first six quarters of the current recovery, the nature of the recovery process has changed dramatically. In fact, during the last five quarters, economic growth has averaged only about 2%, not only far below the rate of growth earlier, but even well below long-term average growth in the United States. This slowdown occurred just when many were predicting that a continuing economic boom was in store, fueled by the tax cuts that were enacted in 1981. At the outset, it should be recognized that there was no economic boom in the first place. The problem stems from confusion between the direction and the level of economic activity — while the economy was moving upward at a very rapid rate during the first half of 1984, economic activity was still considerably below its potential, reflecting the extremely weak conditions from which the recovery began. Thus, unemployment, capacity utilization, profits, and other important measures of economic performance were still far from satisfactory at that time, and in most cases, had not even returned to the relatively sluggish levels which existed in the 1970s. In fact, many industries and geographic areas were still extremely depressed, having experienced virtually no recovery at all.

Two other important aspects of the earlier stages of the economic recovery are also essential to help understand why rapid growth has been so short-lived. First, the recovery was not caused by tax cuts alone; to a significant degree, what was in place was a cyclical rebound caused by a number of relatively transitory factors, such as inventory rebuilding in many industries, the large amount of pent-up demand for consumer durables and other goods that had previously built up, and an extremely loose monetary policy. The stimulative impact of these factors, as well as of the tax cuts and rising budget deficits, was bound to diminish in magnitude. Second, the faster-than-expected recovery during 1983 and early 1984 was simply using up idle resources more rapidly than had been anticipated, rather than reflecting any major improvement in the long-term growth potential of the U.S. economy.

So for all of these reasons, the rosy extrapolations regarding future growth were premature and dangerous to begin with — the fact that economic growth has moderated thus comes as no surprise. What is highly disturbing, however, is the **degree** to which the pace of economic expansion has slowed. Growth over the last five quarters has not only lagged far behind the "New Era" expectations, but as mentioned earlier, it has even been considerably below the long-term average of the U.S. economy, even though the recovery is far from complete. Why? In my view, in addition to the fading out of the temporary growth stimulants mentioned earlier, the slowdown in economic growth is also being caused by the enormous and growing Federal budget deficit which has in large part resulted from those massive tax cuts enacted in 1981.

How could the same factor actually help speed the recovery at one time and, at another, act to slow it down? In 1983 and much of 1984, when private borrowing was relatively low, when the Federal Reserve was highly accommodative, and when a large fraction of the Federal deficit actually reflected the low level of economic activity (i.e., was cyclical in nature), large and growing deficits stimulated demand and thus helped propel the economy forward. More recently, however, these underlying conditions have changed — private borrowing has increased rapidly in tandem with the recovery thus far; the Federal Reserve is not permitting the growth in money and credit at the relatively high rates experienced earlier in the recovery on a continuing basis; and most importantly, the rising deficit now primarily reflects a growing structural imbalance between revenues and expenditures rather than cyclical factors. These growing deficits are keeping interest rates well above historical levels, which is primarily responsible for the increase in net foreign demand for U.S. assets which has caused the U.S. dollar to become so overvalued on foreign exchange markets. In effect, interest rates and the U.S. dollar are too high to permit more rapid economic growth and are thus the two principal factors preventing a faster completion of the recovery process -- in turn, both are primarily caused by high and rising Federal budget deficits at a point in the recovery when they should be falling sharply. Federal deficits have thus become counterproductive for economic growth -- the direct stimulus of such deficits is now being outweighed by the adverse effects of the excessively high interest and dollar exchange rates which they have caused.

Interest rates are especially high when measured relative to the inflation rate for goods (which strongly influences capital spending and inventory decisions) and relative to wage growth (which affects the demand for housing). These real interest rates have remained extremely high, despite an accommodative monetary policy (especially during the last several months), and despite the massive inflow of foreign capital from overseas and cutbacks in foreign lending by U.S. banks, because of the enormous amount of Treasury borrowing. This is compounded by the economy's increased sensitivity to high rates because many of the most necessary and highest-return expenditures and investments were made earlier in the recovery -- in more and more cases, those now being considered are not economical at current interest rates.

The situation with respect to the U.S. dollar is similar -- although it has weakened some in recent months, it remains at least 30% overvalued on a purchasing power parity basis. The overly strong dollar exchange rate is now restraining economic activity in the United States in several ways: **(a)** It has been a major factor behind the very sharp and widespread increases in import penetration, and very soft exports, which are causing enormous U.S. trade deficits despite falling oil imports. Until now, most of the growth in imports has come from foreign-based corporations — however, more U.S. companies are now beginning to shift production overseas, suggesting that substantial increases in imports from foreign operations of U.S. based companies, and more sluggish U.S. exports, are likely. Furthermore, import prices were not reduced when the dollar continued to strengthen in late 1984 and early 1985 — profits earned in U.S. markets by foreign companies just widened further. Thus, the recent decline in the dollar will probably not result in higher prices for imported goods, and therefore is probably not sufficient to significantly improve the competitive position of U.S. companies in world markets. Therefore, unless the dollar drops far more sharply, the trade deficit may become even larger in the months ahead. **(b)** As evidenced by recent earnings reports, the strong dollar is causing a profit squeeze by preventing most industrial companies from raising prices; this in turn is reducing the growth in capital spending. **(c)** Many companies are increasing their efforts to cut wages in order to at least partially offset declining profits — this, combined with the direct job loss in the relatively high-wage manufacturing sector, has caused a sharp deceleration in the growth in personal incomes, and thus slower growth in consumer spending. Furthermore, the benefits of relatively low inflation caused by the strong dollar are less than is commonly assumed, since they are largely offset by the squeeze on profits and/or cutbacks in wages -- this source of disinflation does not stimulate economic activity to the same extent as does lower inflation caused by rising productivity.

Several industries have already been devastated by the high interest rate/overvalued dollar combination. In fact, while the woes of the agricultural sector have been heavily publicized, what has been less noticed is that the industrial sector, which accounts for about 30% of total economic activity in the United States, has stagnated since mid-1984. Furthermore, the squeeze is now beginning to spread. Even high-tech industries are experiencing a significant loss of orders due to the direct and indirect effects of high interest rates and the overvalued dollar. And parts of the service sector, which previously had been relatively strong, are beginning to be adversely effected. This is true both for various business services, as demand from manufacturing companies falls, and for some household services, as the job and income loss associated with declining manufacturing and other interest and exchange rate sensitive industries increases. This will dispel the myth that the U.S. economy can continue to grow at healthy rates when a sizable fraction of it is not growing, or is actually declining — in fact, exactly the opposite is the case.

Current Economic Conditions

Several recently released statistics are being cited as evidence that a major acceleration in economic activity may now be taking place. However, such a conclusion is not warranted; more likely, sustained strong growth will not be realized during the remainder of this year and 1986, with only a very modest acceleration the best that can be hoped for. These recent data include the following:

1. **Auto Sales:** Auto sales surged to near record levels during late August and September, reflecting two major factors. First, low-cost financing is now being offered by the major domestic manufacturers -- on average, more than $1,000 can be saved over the life of a typical auto loan. Second, the end of the car haulers' strike permitted many cars which had been previously ordered to be delivered (the auto sales statistics measure deliveries, not new orders) in recent weeks. Both of these factors are temporary, however; in fact, as much as 60% of increases in auto sales resulting from promotional programs in the past have been borrowed from future periods. Thus, recent sales are not indicative of a new uptrend in auto sales. And, the increase in auto sales did not increase third-quarter GNP, since they resulted in a reduction of inventories of 1985 models rather than higher production.

2. **Retail Sales:** Retail sales rose a relatively strong 1.9% in August. However, most of the rise was the result of a sharp increase in auto sales in late August -- nonauto sales rose by a very modest 0.4%. Second, sales in the nonauto sector were probably buoyed by an early start to the school year, which shifted some preschool spending from September to August. Finally, retail sales for July, which were already sluggish, were revised further downward. Thus, the August data do not indicate any basic uptrend in retail activity.

3. **Unemployment:** The unemployment rate fell by a surprising 0.3 percentage points in August. However, while the increase in employment (as measured by both the household and payroll surveys) was reasonably good, the absence of any growth in the labor force accounted for a significant part of the reduction in the unemployment rate. The labor force has in fact been relatively flat all year, which helps explain why unemployment has not trended upward despite the sluggish economy. The largest decline in unemployment in August was among teenagers, which may reflect typical seasonal adjustment problems at this time of the year. Unemployment has already bounced back up in September, and more increases are likely in coming months. Finally, the increase in payroll employment in September was very small.

4. Leading Indicators: The index of leading indicators rose 0.7% in both July and August. However, most of the increases were in the money supply and the stock market, rather than in indicators more directly reflective of the health of the "real" economy. Finally, periods of rapid growth have historically been preceded by much stronger increases in the index than those experienced in recent months.

5. Trade Deficit: The trade deficit in both July and August were about $2.5 billion less than in June -- however, most of the difference resulted from temporary declines in imports of oil and foreign cars which are not likely to be sustained. Furthermore, exports were weak in both months, continuing the pattern of recent months. Thus, the trade deficit will likely resume its upward trend during the next several months.

6. Housing Starts: Housing starts rose to its highest level in many months during August; however, while some improvement in housing activity is likely in view of recent declines in mortgage rates, almost all of the August increase was in multifamily construction. This surge in apartment and condominium construction reflects anticipation of tax reform, which would curtail many of the benefits associated with such construction, as well as an expected cutback in industrial revenue bond financing. In view of high vacancy rates throughout much of the United States, August multifamily construction activity seems unsustainable.

Thus, these data do not provide conclusive evidence that a major acceleration in economic growth is already underway. What is occuring is a modest pickup in economic activity that appears to be in line with the third-quarter flash report for real GNP -- that is, when all of the statistics are sorted out, the economy is currently growing at a rate of about 2.5%. While this is significantly better than the growth rate during the first half of this year, it is still not sufficient to help alleviate some of the economic problems which we are now experiencing.

Fiscal Policy Outlook

Congressional budget projections incorporating the recently adopted budget resolution indicate that the deficit will decline to about $130 billion per year by the end of the decade from the FY 1985 estimate of $210 billion, instead of rising to nearly $275 billion under previous law. However, spending reductions will fall short of the targets in the budget resolution and the economy will be far weaker than Congressional estimates. Thus, the deficit will remain near $200 billion per year, barring any new actions. This is not sufficient to eliminate the substantial pressure on interest rates and the U.S. dollar that has been caused by large structural budget deficits. The still poor deficit outlook reflects:

1. National defense accounts for almost half of the total spending reductions in the budget resolution for the next three years. However, actual spending may exceed the budget resolution targets, since it is unlikely that: (a) any of the major weapons systems will be scaled back sharply--in fact, the recent shortfall in military expenditures is in part the result of delays in orders and deliveries of various weapons systems, rather than actual cutbacks; (b) any more military bases will be eliminated because of local Congressional resistance; and (c) operations and maintenance expenditures can be scaled back further.

2. Reconciliation instructions for a large portion of the nondefense cuts were also not included in the budget resolution -- it is thus up to the various appropriations committees to find ways to produce the savings. However, it is very likely that some of these cuts will not materialize in the appropriations process, because the programs involved have large constituencies in the Congress -- this is especially true for farm and education programs.

3. The economic assumptions underlying the budget resolution are extremely optimistic -- they are in fact the same assumptions that the Administration used as part of its budget last February -- implying average economic growth of nearly 4% per year through the end of the decade. However, this significantly overstates long-term potential growth: (a) The growth in the labor force has slowed markedly since 1980, in part reflecting a slowdown in the rate of increase in the participation rate. This has occurred despite the reduction in marginal tax rates in recent years, which was supposed to have stimulated more work effort. (b) The rate of increase in productivity has been below the rate of increase during the first two years of most previous recoveries. While productivity growth is exceeding its growth during much of the 1970s, the relatively modest rate of increase during the recovery thus far is somewhat disappointing in view of how rapidly GNP grew in its early stages and in view of the emphasis on productivity enhancement and cost cutting. Most significantly, productivity growth has slowed sharply during the last several quarters, also suggesting that, at least at this point, the improvement in the underlying trend growth in productivity has been very modest at best. (c) Despite sharp cuts in marginal tax rates, the enactment of IRAs, Keoughs, and other direct savings incentives, extremely high nominal and real interest rates, and declining inflationary expectations, the personal saving rate during the last four years has averaged considerably less than in earlier years. Thus, even after adjusting for other factors which hold down savings, it does not appear that there has been any increase in savings as a result of policy changes in

recent years. (d) Profits also remain depressed despite the sharp increase during the last two years. Profits as a share of GNP are still below the levels during much of the 1970s, although the quality of earnings has improved. Furthermore, profits have weakened during the last several quarters. (e) Despite the so called "investment boom" now underway, real net investment as a share of GNP has only recently returned to the levels which existed in earlier periods. Investment was extremely depressed in the early 1980s, so that the sharp increase in investment spending in 1983 and 1984 simply returned us to previous levels. In addition, a relatively large fraction of current investment is for short-lived assets, many of which do not add significantly to capacity. Most significantly, there is no evidence that net investment relative to GNP is now, or will be, any higher than it has been historically despite tax cuts and recently enacted investment incentives. (f) The U.S. competitive position in world markets has deteriorated dramatically in recent years, and is probably at its lowest point in the entire postwar period. This is certainly not a favorable development for long-term growth. (g) The unevenness of the recovery may also limit future growth. Many industries, regions, and economic sectors have hardly participated in the recovery at all, indicating a high degree of imbalance and that the economy has not reached a fully prosperous and healthy condition.

When these factors are taken into account, long-term growth is not likely to exceed 3.0% to 3.25% annually, even under optimum conditions; without a major recession, and allowing for a closing of the gap between current output and potential. This would mean significantly higher deficits than currently being forecast by the Congress and the Administration.

The shortfall in economic growth during the remainder of the current year alone will increase future deficits by nearly $20 billion a year, only a small portion of which will be offset by lower-than-expected interest rates.

Monetary Policy — Is the Fed pushing on a string?

There is almost universal agreement that the Federal Reserve has pursued a much more accommodative posture since late 1984 -- this is best indicated by the very sharp increase in the growth of nonborrowed reserves, as well as the relatively strong increase in the monetary base, since that time. Growth in the basic money supply has also been quite rapid -- in fact, the 12% annual rate of increase in M1 since September 1984 represents one of the longest periods of double-digit money supply growth in the entire postwar period. Despite this easing in monetary policy, however, the economy has grown very slowly, with only a modest pickup in economic growth now taking place. In my view, this reflects the likelihood that the stimulative impact of the recent strong growth in M1 is being overstated, for the following reasons.

1. Although interest rates have come down sharply, they remain extremely high in real terms. Thus, real short-term interest rates to finance inventories, real long-term rates to finance capital expenditures, and real mortgage rates to finance new home construction, are all still far above historical levels. Furthermore, real interest rates are now having a more restrictive effect than earlier in the recovery cycle, since a substantial portion of the pent-up demand for housing, durable goods and some types of business equipment that was created during earlier recessions has already been filled.

2. Although M1 has grown at a 12% annual rate over the last 10 months, the growth in M2 and M3 has been significantly lower. It is likely that the growth in M1 has in part resulted from a shift into interest-bearing checking deposits from other instruments — this shift has been caused by the downward trend in interest rates because of the reduced opportunity costs associated with these deposit forms. Recent difficulties among several non-Federally insured thrift institutions may also be causing some shifting of funds from thrift accounts to checkable deposits at large commercial banks, and thus into M1. In this context, it should be noted that the other checkable deposits component of M1 has accounted for much of the growth in M1 during the last ten months. Thus, M1 may include a higher component of "savings" relative to transaction balances than has been the case in the past. The relationship between M1 and domestic economic performance has also been weakened by financial market deregulation and by the rapid growth in imports in recent years. As a result of these factors, M1 growth currently exaggerates the degree of monetary ease somewhat.

3. The effect of the Fed's easing is being significantly offset by a number of factors, most of which are highly unusual at this stage of the recovery: **(a)** Capacity utilization in manufacturing is both falling and relatively low — operating rates have traditionally been over 85% (and rising) during the third year of economic recoveries. Rising excess capacity is preventing more buoyant capital spending by reducing the expected return on many projects, offsetting the impact of declining rates. **(b)** Vacancy rates among multifamily residences, office buildings, and commercial structures are also relatively high and rising -- this is already beginning to depress new construction, even with lower interest rates. **(c)** The recent decline in the value of the U.S. dollar on foreign exchange markets has raised hopes of an early turnaround in the U.S. trade deficit. However, I believe such an expectation is premature -- my work suggests that the trade deficit will widen during the remainder of 1985 and early 1986 in response

to the strengthening of the dollar which occurred during 1984 and early 1985. In addition, the trade deficit during the months ahead will be aggravated by: rising imports of autos in response to the elimination of voluntary quotas on Japanese cars, some increases in oil imports now that refined product inventories have been reduced sharply, continued relatively slow growth outside the United States, and the continuing shifting of production by many U.S. companies to their foreign operations. Furthermore, as stated earlier, the recent decline in the dollar has not yet significantly affected the prices of most imported goods -- its main effect thus far has been to reduce the extremely high profit margins associated with sales of foreign products in U.S. markets. Thus, a much larger decline in the dollar is necessary for any major turnaround in the U.S. trade deficit even after the next several quarters. **(d)** Inventory liquidation, such as has been occurring in recent months, is also unusual at this point in the recovery. In fact, the third year of recoveries has historically been characterized by large inventory accumulation, which has frequently sown the seeds of the next recession. Current inventory policies reflect concern regarding future sales, as well as the still high cost of financing inventories in relation to stable or declining prices for industrial commodities and finished goods. I thus expect that, even after the current liquidation process is over, strong inventory rebuilding that is consistent with rapid economic growth will not occur. **(e)** The loss of high-paying manufacturing jobs, and the scaling back of wage increases throughout the economy in response to weak profits, have caused a dramatic deceleration in income growth -- this again is highly unusual at this stage of the recovery. This slowdown in income growth is especially troublesome because household debt has increased significantly during the last year and because the saving rate is relatively low. The saving rate in recent months has actually been near all-time low levels -- while this in part reflects the weakness in interest and farm income, much of which reduces savings rather than consumption, it also reflects the likelihood that consumer spending has not yet fully adjusted to the loss of income associated with rising imports. In effect, increased spending by consumers for imported goods does not generate equivalent income, as is the case for spending on domestically produced goods -- eventually, this income shortfall will limit future spending increases. This combination will offset some of the stimulative effects of recent declines in interest rates on consumer spending, and will thus limit the growth in such spending during the period ahead. **(f)** While declining mortgage rates do stimulate single-family home construction (each 1% decline in mortgage rates will increase single-family starts by 125,000), the slowdown in employment and income growth represents a major offset. Furthermore, minimum downpayment and income standards for the issuance of new mortgages are being tightened as a result of newly implemented FNMA policies. This will further limit the only modest pickup in housing that had previously been expected.

In my view, the factors described above will continue during the period ahead, so that economic growth will continue to lag far behind the growth in M1.

Is the capital spending boom over?

After surging earlier in the recovery, business investment has lost considerable steam, reflecting the following: **(a)** The surge in capital spending in 1983 and early 1984 came from an extremely low base, and thus in part was simply a makeup for extremely depressed spending during the prior several years. **(b)** The stimulative effect on the desired level of capital stock of investment incentives enacted in 1981 has in large part already been realized -- therefore, they will not continue to contribute to the growth in capital spending. **(c)** Capacity utilization is falling in many industries as a result of weak demand and/or increased outsourcing. **(d)** The sharp decline in profits in the last several quarters has dramatically slowed cash flow. The slowdown in capital spending is highly evident from the recent pattern of nondefense capital goods orders (which have been on a downward trend since last summer), from recent plant and equipment surveys (which project little growth **during** the course of 1985 despite a significant year-over-year gain), from recent cutbacks in plant construction, and from signs that the commercial and office building construction boom of recent years is now beginning to taper off. It is thus clear that capital spending is not in a position to lead an acceleration in economic activity in the period ahead -- its outlook depends heavily on the general economic and profits outlook.

Summary of the Short-Term Outlook

In my view, a number of factors will combine to prevent a recession from occurring during the remainder of this year and 1986. These include the following (some of which were discussed earlier):

1. While the Fed's easing will not produce an economic boom (for the reasons already cited), it has been sufficient to prevent the economy from worsening. In particular, the increased liquidity which has resulted from the Fed's policy shift has thus far primarily bolstered the demand for stocks and bonds (as well as imported goods) -- eventually, however, the increase in wealth created by higher prices of financial assets will be a modest stimulus to the demand for domestic goods.

2. Commodity prices remain very weak, despite the recent decline in the value of the U.S. dollar -- while this in part reflects still weak demand, it is primarily the result of enormous supplies and overcapacity. Relatively low inflation is permitting some growth in purchasing power despite the slowdown in income growth. Furthermore, a large part of the slowdown in personal income growth is the result of declining interest income in response to lower interest rates -- this is reducing savings to a greater extent than spending, as mentioned earlier.

3. Even with cutbacks, defense spending will continue to grow as previous appropriations are spent.

4. Despite the profit squeeze, cash flow continues to hold up relatively well because of increasing depreciation allowances -- this will prevent capital spending from falling sharply.

5. Inventories are not now excessive in most sectors.

However, it is equally unlikely that rapid economic growth on a sustained basis can occur during the remainder of 1985 and 1986, for the reasons discussed earlier. To review, these include the following:

1. The likelihood that both interest rates and the dollar will increase somewhat in response to even a modest acceleration in economic growth in view of the still poor outlook for the Federal deficit. This will occur because rising credit demands from the private sector will be necessary to finance a significant portion of any increase in demand associated with faster growth -- this is especially true in view of slow income growth and the low savings rate of households, and in view of the weakness in profits which is slowing the growth in cash flow in the corporate sector. Furthermore, much of the improvement in the economy will be housing-related, which is highly dependent on borrowed capital. These increases in credit demands, following very slow growth in such demands so far this year, will add to still high Treasury borrowing at a time when the Federal Reserve may be unwilling to continue to increase reserves at the rate at which they have grown since late last year. Any increase in interest rates and/or the dollar at this stage of the recovery, especially in view of the economy's increased sensitivity now in comparison with earlier stages of the recovery, would slow economic growth shortly thereafter.

2. As discussed earlier, any significant improvement in the trade deficit is not likely during the forecast period. This reflects the fact that a much larger decline in the dollar will

be necessary to affect import prices relative to those of goods produced in the United States (especially since any small declines in the dollar will simply be absorbed in foreign profit margins); the long lags between changes in exchange rates and their effects on imports and exports; and the continued shifting of production by many U.S. companies to their foreign operations.

3. For reasons already discussed, the outlook is for only modest growth in consumer spending at best. In fact, declines in auto sales later this year will actually cause total household spending to decline during that period.

4. Companies remain cautious about rebuilding inventories, so that inventory investment will not likely lead an acceleration in economic growth.

5. While a pickup in economic activity from other sources could eventually lead to stronger capital spending, it is unlikely that such spending could lead the growth process.

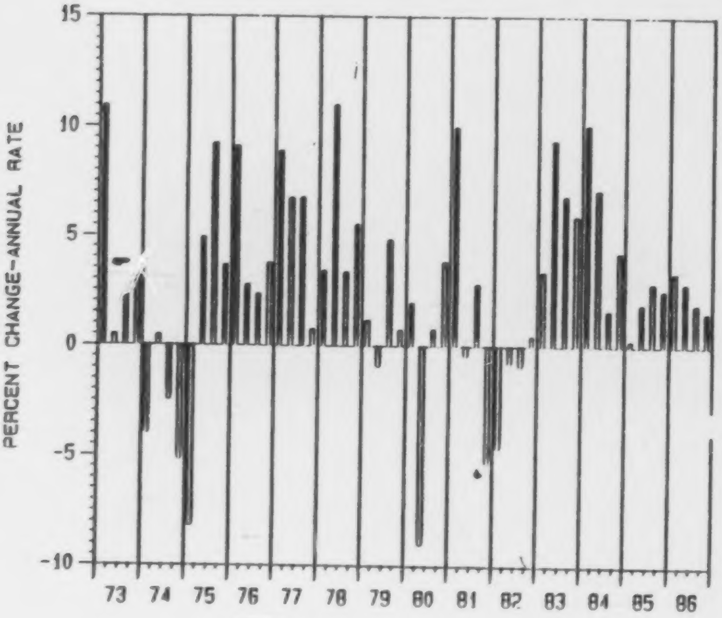
On balance, therefore, the outlook for the remainder of 1985 and 1986 is as follows: **(a)** a pickup in growth will occur later this year and in early 1986; **(b)** it will be relatively modest (in the 3% range); **(c)** growth will slow again in the latter part of 1986 as a result of some upward pressure on interest rates early next year in response to the pickup in economic growth and the likelihood that foreigners will accumulate dollar assets at a slower rate; **(d)** on average, the next year and a half will continue to be characterized by the same pattern of slow and erratic growth already underway; and **(e)** despite the slow growth outlook, the near-term risks are mostly on the downside. The outlook for GNP, and other economic indicators are summarized in **Figure 1** and **Table 1** on the following page.

Table 1
Forecast Summary Table
(percent)

	1982	1983	1984	1985	1986	1987
Real GNP	-2.1	3.7	6.8	2.3	2.6	3.3
Industrial Production	-7.2	5.9	11.6	2.2	2.1	3.2
Real Consumption	1.3	4.8	5.3	4.0	2.9	3.2
Real Fixed Investment	-6.8	9.7	18.0	5.8	2.5	1.8
Consumer Price Index	6.2	3.2	4.5	3.5	3.5	4.5
GNP Deflator	6.0	3.8	3.8	3.6	3.5	4.4
Pre-Tax Profits	-25.2	22.8	14.4	-2.6	2.0	9.0
Unemployment Rate (%)	9.6	9.4	7.4	7.2	7.3	7.0
Prime Rate (%)	14.9	10.8	12.0	9.9	9.9	10.1
Auto Sales (million)	8.0	9.2	10.4	10.9	10.4	10.8
Housing Starts (mil.)	1.06	1.7	1.77	1.75	1.60	1.64

FIGURE 1

REAL GROSS NATIONAL PRODUCT



Major Forecast Assumptions

The major assumptions underlying the forecast are as follows:

Major Forecast Assumptions

1\.

Tax Increases * (billion $)	1986	1987
Personal Taxes	0	-15
Corporate Taxes	0	0
Excise Taxes	3	6

2\.

Expenditure Reductions (billion $)	1986	1987
Defense	10	30
Nondefense	10	20
Interest	3	7
	23	57

3. Interest Rates
See-Saw Pattern
Average 3 Month Bill Rates 7.6% 1985-87

4\.

Food Price Increases (% Change)	
1985	1.8
1986	2.3
1987	4.2

5\.

U.S. Dollar (% Change)	
1985	6.2
1986	-10.0
1987	-6.8

6\.

Oil Prices ($ Per Barrel)	
1985	26.03
1986	24.57
1987	24.28

7\.

M1 Growth (% Change)	
1985	8.6
1986	8.5
1987	7.1

8. International Economic Growth: It is assumed that growth in other industrialized countries will accelerate somewhat, resulting from more fiscal stimulus and lower interest rates. Economic growth in the OECD countries other than the United States is expected to average near 3.0% per year during the forecast period.

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* Assumes phased-in 10% personal tax rate reduction in 1987 and 1988. Also phases-in increases in personal exemption and lower corporate tax rates, and scaled-back investment tax credit and state and local deductions.

Short-Term Forecast Risks

I not only believe that modest economic growth on average is the most likely outcome, I believe that most of the risks are on the downside. These include the following:

1. It is possible that the trade deficit will worsen more than I currently expect, especially if more and more companies accelerate their outsourcing programs.

2. In view of the extremely low saving rate, a significant retrenchment by consumers cannot be completely ruled out for the immediate future. Such retrenchment could in fact be triggered by any further strains in the financial system, such as the failures among several thrift institutions which have recently occurred.

3. While a sharp decline in the dollar is highly necessary to restore U.S. competitiveness in world markets, a rapid decline prior to any meaningful budget deficit reduction could actually worsen the short-term outlook. This could occur because it would probably be accompanied by a reduced willingness of foreigners to hold large amounts of U.S. dollar assets — this could cause sharp increases in U.S. interest rates. The adverse effects of rising rates in the short term would far exceed the short-term benefits to the U.S. trade deficit from a falling dollar, in view of the long lags on exports and imports from changes in exchange rates.

There are also some upside risks, the major one being that oil prices may come down more rapidly than the gradual decline now being assumed. This would cause inflation to be even lower than now expected, bolstering real income and probably causing some additional small declines in interest rates.

The Federal Deficit and Long-Term Economic Growth

As mentioned earlier, I believe that the outlook for long-term growth is not as favorable as current Administration forecasts would suggest. This reflects the likelihood that long-term potential growth is probably only in the range of about 3.0% per year — thus, even assuming that the current gap between actual performance and potential is closed, the maximum economic growth that can be expected during the next five years is only in the 3.0% to 3.25% range per year. Furthermore, in my judgment, even this rate of growth cannot be achieved under current fiscal policies.

As I discussed earlier, the large and growing Federal budget deficit has now become counterproductive for economic growth. Furthermore, the outlook for the deficit is still extremely poor — unless it is changed significantly, the pattern of slow and erratic economic growth that we have already experienced during the last year will continue, at best. Investment in particular will remain well below its potential level and, in fact, could drop sharply if foreigners decide to supply less funds to U.S. capital markets. Such a change in the willingness of foreigners to hold dollar assets would probably offset the more accommodative Federal Reserve stance and cause upward pressure on U.S. interest rates, leading not only to a decline in investment, but to weakness in other interest-sensitive industries as well. In effect, in the absence of significant reductions in future deficits, it will be virtually impossible for lower interest rates and a significant decline in the dollar to occur simultaneously (unless, of course, we experience a severe recession). But to sustain strong economic growth, it is necessary for both interest rates and the U.S. dollar to be significantly lower than current levels. Furthermore, any effort on the part of the Federal Reserve to offset the adverse effects on interest rates of growing Federal budget deficits on a long-term basis is likely to be counterproductive because it would require extremely rapid growth in money and credit on a sustained basis — in the long term this will lead to a major acceleration of inflation, upward pressure on interest rates, and probably an even weaker economic environment.

In sum, the long-term consequences of large Federal budget deficits would be as follows: (a) keep real interest rates and/or the U.S. dollar relatively high, (b) require larger and larger future tax increases just to service the rapidly growing Federal debt, (c) to the extent that foreigners hold an increasing share of that debt, interest payments will leak outside the United States, squeezing U.S. living standards. The net effect would be relatively slow growth and stagnant or declining living standards. Therefore, by far the most urgent policy priority in the United States is to adopt measures which would place deficits on a significant downward trend during the years ahead.

Inflation and Unemployment

In my view, the outlook for inflation remains highly favorable for at least the next few years. This reflects a number of factors: (a) the downtrend in energy prices is likely to resume, reflecting substantial excess capacity in both the oil and natural gas industries; (b) food supplies remain extremely large so that any sharp acceleration in food prices during the next year or two is highly unlikely; (c) despite smaller productivity increases, cost-push inflation remains very low in view of the continued deceleration in rate of wage increases, especially in the manufacturing sector. Furthermore, while the growth in productivity has slowed, it does appear that there has been some improvement in the underlying trend growth in productivity relative to the 1970s; (d) capacity utilization remains relatively low in much of the economy, with no significant upward pressure likely in the foreseeable future. This is also true on a worldwide basis for most industries. Thus, it is unlikely that the kind of shortages and bottlenecks that are usually necessary to produce a major acceleration in overall inflation will occur during the next several years; (e) the economy remains extremely competitive, in part because of deregulation in many industries, in part because of the overvalued dollar, and in part because of large excess capacity. This high degree of competitiveness not only will limit any acceleration in inflation, but is encouraging more and more companies to intensify cost control efforts, which will also have a favorable effect on future inflation rates.

Some increase in the inflation rate is likely, however, if the recent downward trend in the U.S. dollar continues. This will not only eventually cause some increase in import prices, but many competing domestic prices will rise as well, as will various commodity prices. In my judgment, the impact on overall U.S. inflation will be relatively modest, however, so that even with a sharp decline, the overall inflation rate is not likely to substantially exceed 5% during the next several years. Furthermore, some acceleration is actually welcome under these conditions, since it will enable many U.S. industries which are now suffering a severe profit squeeze to experience some recovery.

With respect to unemployment, even my standard forecast, which includes a modest acceleration in economic activity later this year, implies that unemployment will rise somewhat. If, of course, the economy remains stagnant or if a recession were to develop during this period, unemployment would rise, probably bringing the overall unemployment rate to at least 8.5% by mid-1986. In my view, any increase in unemployment during the period ahead would be a matter of great concern since unemployment is already too high because we have not had a complete recovery from the long period of economic stagnation in the late 1970s and early 1980s.

Both the inflation and unemployment outlook, particularly in the longer term, are thus not quite as favorable as both the Administration and the Congressional Budget Office have assumed in their most recent long-term forecasts.

Policy Recommendations

In my judgment, the long-term economic outlook can be enhanced, producing economic growth averaging between 3.0% and 3.25% per year, if the current policy mix is adjusted — a significant reduction in future deficits is absolutely essential for more favorable long-term growth. Such deficit reductions would take considerable pressure off interest rates and the U.S. dollar on foreign exchange markets, and permit the increase in private borrowing that would be necessary to finance faster economic growth. A continued relatively accommodative monetary posture would also be possible under these conditions, because it would be possible for the Federal Reserve to keep interest rates lower without extremely rapid growth in the money supply on a sustained basis. Thus, from a policy perspective, deficit reduction is by far the number one priority.

Actions should be sufficient to produce a gradual decline in the deficits, beginning in 1985, of approximately $30 billion per year from the preceding year (if economic conditions permit), so that the deficit will be about $50 to $75 billion by the end of the decade. Even after taking into account the fact that reductions in deficits will build on themselves by reducing interest expense in succeeding years, the actions required will be very substantial. In my view, while I favor as much in the way of spending reductions as is possible, it will be impossible to close the deficit gap sufficiently just on the spending side, even if a significant cutback or stretching out in the military buildup is adopted. Thus, some tax increases will likely be necessary as well. The tax cuts that were enacted in 1981 were too large because of this country's continued commitment to a safety net, because of the current military buildup underway, and because of the difficulties of significantly reducing entitlement programs in the short run. While some of those tax cuts have already been reversed, additional revenue recoveries will be necessary. However, the net effect of spending cuts and tax increases which reduce future deficits will be positive in the long run because the loss of fiscal stimulus will be more than offset by the favorable effects of lower interest rates and a lower dollar. Furthermore, there will still be ample fiscal stimulus to promote a healthy and balanced economic recovery.

With respect to budget cuts, I believe that in addition to a stretching out of the military buildup, any additional cuts that are made should be concentrated in the area of entitlements, particularly for health and pension programs. I advocate capping the cost of health care and implementing other reforms that will significantly reduce the cost of medical care in the years ahead. Furthermore, I think it is essential that we gradually increase the retirement age for full Social Security benefits as soon as possible, that the indexing formula for Social Security and other entitlement programs be scaled back, and that a means test be strongly considered for many of the entitlement programs. Finally, pension benefits for government employees will have to be reduced as well. It should be noted that despite the poor deficit outlook, significant spending reducitons have already taken place. These include a slowing in the previously projected growth in military spending, as well as actual cutbacks in many social programs. However, much of this has been offset by the enormous increases in interest expense.

On the tax side, I believe that tax increases should be consistent with the following objectives:

1. To the extent possible, any increase in personal taxes should be accomplished by broadening the tax base rather than by incrasing marginal tax rats. This can be done primarily by eliminating many of the loopholes, tax shelters, and deductions that now result in sizable revenue loss.

2. Since I believe that the distribution of the tax burden has been shifted dramatically away from the upper income groups toward those with lower and middle incomes in recent years, I would strongly oppose any tax increases in the years ahead which are relatively regressive. In fact, I would hope that the tax changes which are implemented will at least partially reverse the trend of recent years, especially since large, regressive Social Security tax increases are already scheduled in the years ahead.

3. I believe that at least a portion of any tax increases should be directed at corporations in view of the sharp decline in the corporate tax burden in recent years, although every effort should be made to limit the adverse effects on investment.

4. Revenues should be raised as much as possible from individuals and corporations who are now not paying their fair share.

5. A new tax infrastructure should not be put in place because of the time it would take and because of the cost of doing so. Furthermore, a straight flat tax or a consumption tax would not be appropriate because they would make the tax structure more regressive than is currently the ease.

In my view, the best way to achieve these objectives and at the same time raise more revenues would be to combine tax reform with deficit reduction. By sharply cutting back various exemptions, deductions, exclusions, tax shelters, etc., it would be possible to both cut marginal tax rates below current levels while at the same time raise additional revenues in order to reduce future deficits -- the other objectives written above can also be accomplished. Furthermore, with appropriate modifications to the Administration's tax reform proposal, the disincentives for investment can be reduced substantially.

Another way of raising some revenues without reducing incentives for saving or investment would be to modify existing features of the tax law to target them more toward productive investment. As an example, a change in the capital gains tax so that only investments on productive assets can qualify for capital gains status deserves consideration.

As this testimony was being prepared, Congress was debating passage of legislation which would require a balanced budget by 1991. While I believe that a gradual decline in the deficit to achieve a balanced budget by the early 1990s is a desirable objective, I have several concerns with the proposal now being debated. **First,** it does not appear to make adequate provisions for a recession -- thus, a $35 billion deficit reduction (from the prior year) would not be appropriate during a recession year. One way to overcome this problem is to define the deficit objective based on the full employment surplus or deficit concept, rather than on actual deficits. **Second,** the Administration has consistently overestimated economic growth in recent years, and as a result, has produced unrealistically low deficit projections. Were this to occur in the future, if this legislation were to become law, major spending cuts would be necessary later on simply because the original projections were unrealistic. Third, my understanding of the proposed legislation is that the necessary adjustments (if projected deficits were not being achieved) would be made by the President, rather than under the current process -- this may shift too much budgetary power away from the Congress. Thus, while I believe in the objectives of the proposed legislation, it appears that several modifications to the current proposal may be necessary.

Trade Policy

Providing solutions to our trade problems over and above adjusting macroeconomic policy requires a multi-faceted approach because of the different causes of our trade deficit.

1. Some of our current trade deficit is the result of structural, cost or product problems which have made it difficult or impossible for various U.S. industries to compete in world markets. Trade theory would suggest that permanent protection for these industries would not benefit either the U.S. or world economies in the long run -- in particular, it would raise costs to consumers and promote ineffeciency. Past experience in providing tariff or quota protection for various industries has, in fact, not been highly favorable. Thus, in my judgment, trade policy should focus primarily on alleviating the hardships that have resulted in these segments of the economy, by supplemental unemployment benefits to provide more income replacement for workers who lose jobs in these sectors; more retraining programs; other modifications in unemployment insurance to promote more mobility; etc. Our policies have moved in the opposite direction in recent years, with many programs that could ease some of the hardships having actually been scaled back.

2. It is clear that a stronger program is necessary to promote fair trade. There have been numerous suggestions made about how to pressure other countries to reduce their unfair trade practices. The President's program designed to identify unfair trade practices overseas, and make stronger efforts to eliminate them, is an excellent first step. However, if this is not successful, I believe the following should be considered.

    - For foreign countries that unfairly subsidize their exports to the United States, a tariff* on such exports to offset the degree of subsidy (provided they are not removed within a reasonable period of time) is appropriate.

    - For foreign countries that subsidize their exports to third countries, low cost financing or other direct subsidies by the United States to offset those provided by foreign countries appear appropriate (if the foreign subsidies are not removed).

    - For barriers to imports overseas, the problem is more difficult. The only solution for those barriers which are not removed is some form of direct retaliation, whereby the United States will restrict imports (preferably by tariff) from those foreign industries which are being protected, or from others, if necessary.

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*Tariffs are preferable to quotas because they will prevent large profit margins from being received by foreign producers--the funds will be kept here. There are other advantages of tariffs over quotas as well.

3. The most significant part of the trade problem reflects the overvalued dollar. Thus, the measures listed above will have only a limited impact on the trade deficit — it will also take many years before trade flows are probably affected at all. Furthermore, even with the recently announced intitiatives of the G-5 countries, it is premature to conclude that the dollar will decline soon enough to alleviate the problems that the bulk of U.S. manufacturing, agriculture and other commodity producers are experiencing. The issue is both one of timing as well as the ultimate value of the dollar — the longer it takes to attain approximate purchasing power parity, the more likely that the industries that are now being impacted will have suffered severe damage from which they may be unable to recover. Those companies that have been forced to dismantle their distribution networks overseas may never recapture their export markets; foreign producers who have been gaining market share in the United States are becoming increasingly difficult to dislodge; and it may be difficult for many companies to bring their production back onshore because the required investment may be too great. Thus, a dollar decline that is too late in coming may not offer the necessary relief.

Thus, beyond the more narrow trade measures discussed above, the key question becomes whether stronger measures are also needed to provide temporary relief to those who cannot compete because of the overly strong dollar, since not doing so may cause irreparable harm to these industries and to the U.S. economy in general. The argument for such relief is strengthened by the fact that their inability to compete is in general not due to their own actions — it primarily reflects inappropriate economic policies here and abroad and changing financial regulations in other countries, which have combined to create an enormous competitive disadvantage for them that they cannot reasonably be expected to overcome. And, even under the best of circumstances, sufficient adjustments to macroeconomic policies on a worldwide basis to enable them eventually to overcome their competitive disadvantage will take many years to implement.

If it is deemed that some relief should be provided, I believe it should be done with the following objectives in mind. **(a)** It should be temporary in nature. **(b)** It should not provide significant relief for those who cannot compete for reasons unrelated to the strength of the dollar, such as their own cost structure, poor quality products, etc. **(c)** It should be independent of actions designed to address unfair trade practices overseas. **(d)** It should not be aimed at any specific country.

Several measures currently being considered by the Congress are designed at least in part to provide such temporary relief -- these include the Bentsen/Rostenkowski/Gephardt proposal which would require a 25% import surcharge on imports entering the United States from several countries if they do not reduce their trade surpluses with the United States. However, there are a number of difficulties with this and other similar proposals, including: **(a)** they address only about 30% or less of the total trade deficit; **(b)** it is unreasonable to address the trade issue on a country-by-country basis because of the differences in product availability, natural resources, etc.; **(c)** the countries involved would probably respond by reducing their exports of some products to the United States, rather than permitting more U.S. imports (this would just deny U.S. consumers products that they may want even at a higher price); **(d)** they could provide relief for those industries which should not be granted relief; **(e)** they could very well worsen the LDC debt crisis (Brazil would be one of the targeted countries); and (f) they could cause the dollar to rise in value.

There are two alternatives that I believe are preferable. **Alternative One** would be to take more steps to drive the dollar down more quickly. Increased intervention by the G-5 countries, if they follow through, is a step in the right direction because the dollar is already weakening -- such intervention is likely to have more impact than when the dollar was strengthening. An alternative to more intervention would be the imposition of a temporary tax on income earned on foreign held assets in the United States. This would significantly reduce the incentive for foreigners to hold U.S. dollar assets and likely drive the dollar down very quickly (in effect, this would be the reverse of the interest equalization tax imposed in the United States to reduce capital outflows in the late 1960s).

Alternative Two would be to implement measures to offset the adverse effect of the dollar on U.S. competitiveness, rather than taking stronger measures to drive the dollar down. One way of accomplishing this would be a floating tariff or surcharge, with the amount related to the degree of overvaluation of the U.S. dollar. For example, if the dollar is deemed to be overvalued by 30%, a 20% surcharge would be appropriate (since this would approximate the portion of the purchase price of imported goods in the United States that benefits from the strong dollar). As the dollar moves up or down, the value of this surcharge could be adjusted accordingly. This approach has the advantage of not providing permanent relief -- U.S. companies would still need to attempt to lower costs since they could not count on a surcharge being in effect on a permanent basis. Furthermore, it will not provide any relief beyond that needed due to the strong dollar -- thus, it would not offset the effects of low productivity or relatively high wage costs in some industries. One limitation is that it would only benefit the import side -- some form of temporary rebate also related to the dollar's strength would also be needed on the export side. The net revenues received from the temporary tariff and export rebate (there would be net revenues because imports now far exceed exports) could be used to fund measures to ease trade-related hardships.

In my judgment, these alternatives are preferable to any measures which have already been proposed to provide temporary relief for U.S. industries suffering from the overvalued dollar. I might caution, however, that neither of these approaches is without problems -- in particular, both are likely to put upward pressure on U.S. interest rates, which in the near term could cause even weaker economic growth than we are now experiencing, especially because the impact on the economy of higher interest rates will come more quickly than the improvements which will result from a lower dollar. Long-term economic imbalances would likely be significantly reduced, however.

However, until the budget deficit is reduced significantly, it will be virtually impossible to achieve both a lower dollar and stable or declining interest rates simultaneously. The argument for pushing the dollar down, or offsetting its impact on relative competitiveness, is that the adverse effects of budget deficits on U.S. economic performance will be shared more equally throughout the economy if interest rates were higher than under the current interest rate/U.S. dollar mix. In addition, a tax on U.S. assets held by foreigners could result in better economic performance overseas by pushing interest rates down in those countries, and by enabling them to use their own savings to finance their internal economic growth. Higher interest rates in the United States might also create more public pressure for additional deficit reduction. Nonetheless, the only complete solution to our trade problems is thus to implement policies which will result in lower interest rates and a lower dollar simulataneously -- in my view, significant reductions in Federal budget deficits are the only way of bringing this result about.

In addition, it is necessary to review whether the current flexible exchange rate system requires modification to prevent the enormous misalignments in exchange rates from continuing, or recurring -- measures to help strengthen U.S. exports on a long-term basis also deserve consideration.

It likely also possible that any measure designed to provide broad-based trade relief will be viewed as protectionist -- the retaliation following enactment of the Smoot-Hawley Tariffs and the 1930's Depression are being used as arguments against the implementation of such measures. While I feel very strongly that permanent protection is highly undesirable, the

Smoot-Hawley analogy is suspect. The situation is currently very different from that of the early 1970s. At that time, the United States was not running a large trade deficit, as it is currently — in fact, the growth in exports in most other countries has been their only significant source of economic strength. It is most likely that they will be forced to accept somewhat smaller surpluses in the short term resulting from U.S. trade measures rather than implementing massive retaliation in order to offset those measures. In fact, quite the opposite might occur — any measures which would reduce their trade surpluses in the short-term might in fact force them to take stronger actions to stimulate their domestic economies. Furthermore, fiscal and monetary policies were at least as responsible for the severity of the Depression as was the wave of protectionism which triggered the enactment of the Smoot-Hawley Tariffs. Perhaps the closest analogy would be the 20% import surcharge adopted in 1971 to reduce the U.S. trade deficit at that time — it met with very little retaliation. Finally, temporary measures designed to offset the problems caused by the overvalued dollar are not comparable to measures which provide permanent protection to specific industries or sectors.

The **Chairman**. Thank you very much, Dr. Chimerine. I would like to direct a few questions to you before going to our next witness, Dr. Behravesh.

Mr. **Chimerine**. Go right ahead.

The **Chairman**. You have answered many of them already. I have to throw out half my list. You hit on every point that I wanted to raise with you.

First of all, you are saying that from your perspective, and from the perspective of Chase Econometrics, you don't see an economy that is going to be growing nearly at the level at which the OMB, the President, the administration say, or even CBO; is that fair?

Mr. **Chimerine**. That is correct.

The **Chairman**. Do you see a great possibility of an economic downturn, and if so, when?

Mr. **Chimerine**. Mr. Chairman, I think we will probably avoid a downturn, because the problems that are affecting the economy right now don't accumulate rapidly enough to produce a sizable downturn. It is sort of a creeping problem. It is the British disease. The British went from being the No. 1 industrial power to being on the bottom of the list, by losing 1 percent per year of real growth.

You add that up and compound it over 20 or 30 years and it is very substantial, but it doesn't all happen at once, and in any one year it is probably not even noticeable. My guess is as long as the Fed remains accommodative—and by the way, if the Fed had not eased a year ago, I firmly believe we would be in a recession right now.

The **Chairman**. I would agree with you.

Mr. **Chimerine**. But as long as they are accommodative, and since we don't have a massive inventory overhang, since oil prices are weak and inflation is low, and real incomes are being bolstered a little bit by low inflation, I think we will probably avoid a downturn, but 2½ percent real growth is not adequate.

It doesn't help us address the key problems affecting the economy. It probably means higher unemployment during the next year or so, And when you look at the underlying factors that cause long-term economic growth, namely labor force growth, the saving rate, productivity trends, investment patterns, and our competitiveness in world markets, none of those have improved, so there is almost no possible way, in my judgment, that we can get 4 percent real growth per year for the next 5 years. To build budget policy on that basis is taking an incredible risk with the future of the U.S. economy.

The **Chairman**. With regard to Gramm-Rudman, you have raised some issues with regard to specific proposals. Do you think the approach that as now passed by the Senate, soon to be contemplated by the House, is an approach that should and could be utilized to deal with the problem of increasing debt and deficits, or are the risks too great in an across-the-board formula approach, from your perspective?

Mr. **Chimerine**. Mr. Chairman, I think you have to separate the approach from the objective. I think the objective is the right objective. Now, we can argue about whether it should be balanced in 1991, or 1992, or between a $25 billion deficit and balance, but by and large we need a gradual reduction in the deficit to bring the debt-to-GNP ratio down. But I think the Gramm-Rudman approach is poor.

First of all, nobody really believes it is going to happen, so as a result, you are not getting any benefit in financial markets right now. A better way to do it would be to put a program in place now that shows the world how you are going to reduce deficits. What are the budget cuts we are going to implement in each of the next 5 years? What are the revenue enhancements we are going to implement in the next 4 or 5 years? What is the kind of deficit they are going to produce? And, of course if the economy turns out to be in recession, you don't want deficit reduction in that year.

Thus, I have severe reservations about the particular legislation, even though I support the objective. I would go about it by putting a program in place now describing how you are going to achieve that objective, and I think that would be a more realistic approach, and it would have more credibility in financial markets.

The CHAIRMAN. I think that there are many people around here, and I would imagine that Mr. Gramm, Mr. Rudman and those in the Senate who voted for it would say to you: But this is a program. It means that we are going to have to reach these targets.

I tend to agree with you. It is not a program; it is procedure. The decisions still have to be made. The tough choices still have to be made in order to reach those targets, and after hearing Dr. Penner, and particularly with a potential for a downturn in the economy, I think that what you are going to end up seeing is this being repealed within 24 months or extremely modified, so that the targets don't even exist at all, and that what we are confusing here is a procedure with real reform and substantive policy change that would get you down to a balanced budget.

I agree 100 percent with the goals: A balanced budget by the beginning of the 1990's; two, fairness across the board; and third, developing some way to force us to do that, but unfortunately I have some of the very same reservations you have.

One last question before we turn to our next witness. You have pointed out what I agree with, and that is that if you really want to move toward a balanced budget by 1990—I am not even sure we can wait until 1991, I would like to see us do it by 1989—you have to put revenues on the table. You also point out that entitlements seem to be off the table.

In other words, we have got to have taxes. Of course, you know that the only person who can bring those to the table is the President around here, because of a thing called a veto gun, and no one wants to go up against a veto gun. But let me ask you a question.

As I talk with so many people in the business community, as I look at the positions that are being staked out even now by leaders in the business community, and since you have to work with that community in terms of economic forecasts, I see many of them now taking a position of no revenues. What does the business community say to you when you say, as you have said to us, look, if you want to get this thing in hand, if you want to deal with this debt, you have got to not only do restraint in spending, but you have also got to bring revenues to the table?

What is their response? I am already hearing many of our major trade organizations, manufacturing organizations, business associations take the position of no revenues, no taxes.

Mr. **Chimerine**. Mr. Chairman, my perception—and really it isn't perception, because as you point out, it represents direct feedback I get from my discussions with some of these key business leaders—is that you were absolutely right as of 2 or 3 years ago.

And a year or two ago when the economy was picking up pretty strongly, they didn't want to hear about deficits. But right now, more and more of them are identifying current economic problems and those they are now experiencing, with the deficit. Second, an increasing number—I can't tell you it is a majority, but an increasing number—recognize that we can't solve that problem without some revenue increases, because the truth of the matter is, Mr. Chairman, with this big military buildup with this country's commitment to strong entitlement programs, and to a safety net, the tax cuts of 1981 were too large.

I think anybody who is honest will admit that that was the case even when we passed the tax cuts, but it is hard to argue against that notion now, I would urge you to consider one other point.

What they want to see—and I think that is a legitimate concern—they want to see a proposal for raising revenues combined with a meaningful program of additional spending reduction, so that it is part of a total package, and it isn't just a tax increase. They don't want to see tax increases. They want to see budget reduction in a reasonably effective way, and if tax changes are made as part of a comprehensive program which will address the deficit, including the spending side, and trade issues, and so forth, and do it in a way that the tax increases don't destroy the incentives for investment, my own judgment is that a majority of the business community will support that.

The **Chairman**. I hope that you are right, but already I have seen statements by the Chamber, the National Association of Manufacturers, conferences of business leaders that are saying no taxes, and of course even if you had a temporary tax, a dedicated source that did not go into the revenue base but just went to the deficit reduction alone, you can't do that under what I am hearing coming from the community, and of course if we are going to have a strong deficit reduction, I think eventually we are going to have to put those revenues on the table. I think we are just kidding ourselves if we think we are going to be able to cut our way out of this sea of red ink in the next 3 to 4 or even 5 years. I don't think that is going to be possible. You are going to have to have some revenues.

Mr. **Chimerine**. Mr. Chairman, may I make one last comment? There are two or three business organizations I am familiar with, including the Business Roundtable and the CED, the Committee for Economic Development, which I think have taken a position that they will support higher revenues, if the tax increases meet certain objectives that are laid out; and second, if they are part of a comprehensive budget reduction program. So I think the organizations you may have mentioned have not yet reached that point, but others have.

The **Chairman**. Dr. Behravesh, welcome from the Wharton Econometric Forecasting Associates. Please proceed.

STATEMENT OF NARIMAN BEHRAVESH, VICE PRESIDENT, U.S. SERVICES, WHARTON ECONOMETRIC FORECASTING ASSOCIATES, INC.

Mr. **Behravesh**. Thank you, Mr. Chairman. I am especially pleased to appear before this committee to discuss the views of Wharton regarding the outlook for the U.S. economy and the implications for fiscal policy. Wharton's projections for the U.S. economy are also less optimistic than those of the administration and the Congressional Budget Office. However, we don't think a recession is very likely in the near future.

In the short run, the major risks to the economy are a freefall in the dollar and a more restrictive monetary policy triggered by higher inflation fears. Either or both of these could lead to higher interest rates and a recession, conceivably.

In the longer run, continued financing of record or near record Federal deficits through capital inflows will turn the United States into the world's largest debtor nation, gradually eroding living standards in the United States. There is no question that the No. 1 priority in fiscal policy should be the reduction in the Federal deficit. Without it, the much needed decline in the dollar and the improvement in trade will be very difficult to achieve.

However, a drastic deficit reduction package such as the one proposed by Senators Gramm, Rudman, and Hollings would bring the economy to its knees if it were not offset by substantial easing of monetary policy and a dramatic turnaround in trade.

A recurring theme in my comments this morning is that the increasing openness of the U.S. economy has changed the impact of fiscal policy on the economy and the ground rules for the conduct of policy. This means that U.S. history may be a poor guide for where we are headed and what we should do. Instead, we may learn something from studying the successes and failures of economic policy in countries with even more open economies. Great Britain, Holland, and Japan may be useful economies to look at.

History has very little to reveal about when the next recession in the United States is going to occur. The typical post-war recovery has lasted some 4 years. Unfortunately, the range around that average is very wide. We had one recovery that lasted 1 year, another that lasted close to 8 years. Fortunately, history is a little bit more revealing about how the next recession in the United States will occur, or rather how it will not occur. Recoveries in the United States rarely die of old age. They get pushed over the brink usually by an outside shock or by a policy overreaction to inflationary fears. This is usually a reaction to stresses and strains that appear in the economy and constraints to growth that begin to show up in the mature phases of the recovery.

There are usually two kinds of constraints to growth in the United States, physical constraints and financial constraints. So far in this recovery, there have been very few physical constraints. I am referring here to capacity utilization, the unemployment rate, and to inventories. In all of these cases there really are no physical constraints to growth.

With regard to financial constraints, that is a little more problematic, because saving both at the consumer level and at the business level has been low in the United States recently. Of course, the Federal Government is dissaving at a massive rate. Fortunately, in the recent experience this has been offset by capital inflows from abroad. However, we cannot necessarily continue to count on these, and in fact they may begin to slow down as the dollar outlook changes.

The key question here is as capital inflows slow down in the United States, what will the Federal Reserve do to ease financial conditions.

We are assuming that there will not be a rapid flight of capital from the United States, and that the Fed will continue to provide adequate credit to keep the economy going. With the inflation rate low in the United States, the Fed has really no reason whatsoever to allow the economy to drift into a recession.

On the other hand, we are not terribly sanguine about the outlook for the United States. We do believe, like Larry Chimerine has stated, that there are quite a few sources of weakness in the United States, so we are looking at an outlook for the U.S. economy that shows substantially slower growth in the next 10 years than we have seen, on average, in the past 30 years or so.

The good news is that inflation will remain relatively low, but this kind of an outlook does mean that the deficit continues to stay in the $200 billion range for at least the next decade.

Looking back a little bit, both the strength in the early phase of the current recovery and the subsequent weakness in the economy can be traced either directly or indirectly to the record Federal deficit. During much of the postwar era a burgeoning Federal deficit on this scale would have crowded out domestic investment. This has not occurred.

Instead, given the flexibility of exchange rates and the increased integration of the United States into the world economy, massive Federal borrowing raised interest rates, attracted foreign investment, and became one of the root causes of a stronger dollar. This, in turn, stemmed exports and stimulated imports.

The result has been the emergence of a two-tiered economy in the United States during the 1980's. The import-competing and export sectors have been hurt badly while the nontrading portions of the economy—specifically services, construction, and defense-related industries—have grown rapidly. This divergence is most obvious when one looks at the statistics on employment. Employment in manufacturing has been flat, but jobs have been growing briskly in the service sector. This dichotomy is also apparent when looking at inflation statistics. Inflation in traded goods—commodities, manufactured products, et cetera—has been very low. Indeed, there has been some disinflation in some sectors.

On the other hand, inflation in nontraded goods and services has ranged from 5 to 7 percent. This split in the U.S. economy, between the trading and nontrading portions of the economy, is likely to persist for some time to come.

Another consequence of the large budget and trade imbalances is the transformation of the United States from a creditor nation to a debtor nation. By the end of this year, the Nation will be the largest borrower in the world financial system. By 1990 U.S. borrowing could rise to $1 trillion a year. The interest payments on this debt could explode, pushing the current account deficit into the $200–$300-billion range.

The future risks relate to two areas. One is a freefall in the dollar, which in my opinion is the largest risk right now. That would be accompanied by a drying up of capital inflows into the United States. The result would be a rise in both inflation and interest rates. This would exacerbate the financial problems that are occurring in the farm sector and in many of the thrift institutions.

So far, the Fed has given a higher priority to sustaining growth in the economy and easing financial strains than to fighting inflation. This has led to very rapid growth in the monetary aggregates. If inflation shows any signs of picking up, the Fed cannot be expected to stay on this course. This is the second type of risk.

One way to interpret the recent Group of Five Agreement on the dollar is that both risks have been reduced somewhat. The five nations have, in effect, committed themselves to bring about an orderly decline in the dollar, So we probably won't get a freefall in the dollar. For its part, the Fed has implicitly agreed to bring U.S. interest rates down further, or at least to let them rise little in the near future.

The longer run risks to the U.S. economy relate to the ballooning internal and external debt. If the entire Federal debt were financed internally, interest rates would rise and private investment would be crowded out, affecting the economy's potential growth. However, more and more of this debt is being held by foreigners. There is nothing inherently wrong with importing capital if it is used for productive investment. Unfortunately, much of this foreign capital is being used to finance the deficit.

In effect, the deficit is like a sponge with regard to these financial inflows from abroad. Thus, in this kind of a situation, future claims on U.S. earnings by foreigners will be paid, at the expense of lower living standards for U.S. citizens.

I turn next to the objectives for fiscal policy. Clearly deficit reduction has to be the top priority.

The G–5 Agreement on the dollar will amount to little if it is not accompanied by a reduction in the U.S. budget deficit and more stimulative policies by the trading partners. This means that a substantial reduction in the deficit is the key element to restoring equilibrium in the United States and abroad. Such action takes priority over tax reform unless the constraint of revenue neutrality can be removed from the tax reform discussion. Moreover, one of the flaws in the tax reform proposals presented so far is that they would all depress investment and hurt industries that have already suffered from the strength of the dollar.

Deficit reduction by itself, however, would not do much to improve the outlook for the U.S. economy. If it were coupled with monetary stimulation and if it resulted in substantial declines in the dollar, then the composition of GNP would shift away from Government spending to exports and investment. This shift would provide the basis for sustained longrun growth over the next decade. We have done a rather preliminary analysis of the Gramm-Rudman-Hollings amendment, and this illustrates the point I have just made.

Cutting the deficit to zero in 1991 from the Wharton baseline, which is quite a bit higher than either the CBO or the administration budget baselines, using only spending cuts and assuming no offsetting stimulus, brings the economy to a grinding halt, pushing the unemployment rate up to 17 percent in a few years.

Of course, it is much more realistic to assume that such a huge cut in the deficit would be accompanied by significant monetary easing and a sharper decline in the dollar. If the dollar fell an additional 24 percent from our baseline forecast, and the Fed pushed up money supply growth by 3 to 4 percentage points more each year in addition, then the unemployment rate would rise only to 9 percent by 1991. The impact would be softened further if the trading partner countries were to stimulate their economies further.

Even with the additional stimulus from monetary policy and the decline in the dollar, there is no question that cutting the deficit to zero by 1991 will be a painful experience.

One of the major problems with legislating nominal targets for the deficit is that it does not allow the deficit to rise in recessions. For example, if a recession did occur in 1986, then attempting to hit the Gramm-Rudman-Hollings targets would prolong the recession.

There are more flexible ways of reducing the deficit that would not have such a procyclical bias. For example, the target could be a reduction in the structural deficit to zero by 1991. Congress would have to agree on an appropriate measure of the structural deficit. There have been a number of measures that have been proposed by the Congressional Budget Office.

The deficit would also have to be reduced by raising revenues. Sooner or later revenues will have to find their way back to the bargaining table. The damage being done by the deficit is far greater than the possible problems created by a well-designed tax increase. One candidate for additional revenues might be a fee on imported oil. In fact, this is a proposal that a number of businessmen have found acceptable.

This kind of an oil import fee would reduce both the trade and the Federal deficits. Because of the expected softening in world oil prices over the next year, this would be a good time to consider some kind of a tax increase along these lines.

In the past, an oil import fee has been opposed because it is regressive. There are ways of compensating for this without damaging the effects of a tax increase.

To summarize, then, there is no question that deficit reduction is the top priority as far as the policy is concerned in the Uinted States. However, a drastic reduction in the deficit along the lines of Gramm-Rudman-Hollings can only work with little pain if it is accompanied by more stimulus from the Fed, by a rapid decline in the dollar, which would bring about a turnaround in trade, and also by more stimulus on the part of the trading partner countries.

Thank you, Mr. Chairman.

[Testimony resumes on p. 99.]

[The prepared statement of Mr. Behravesh follows:]

Prepared Statement of Nariman Behravesh

SUMMARY AND INTRODUCTION

Mr. Chairman, I am pleased to appear before this committee to discuss the views of Wharton Econometrics regarding the outlook for the U.S. economy and the implications for fiscal policy.

Wharton's projections for the U.S. economy are less optimistic than those of the Administration or the Congressional Budget Office. However, we don't think a recession is very likely in the near future. In the short run, the major risks to the economy are a freefall of the dollar and a more restrictive monetary policy triggered by inflation fears. Either or both of these could lead to higher interest rates and a recession. In the longer run, continued financing of record or near-record federal deficits through capital inflows will turn the United States into the world's largest debtor nation, gradually eroding living standards.

There is no question that the number-one priority in fiscal policy should be the reduction of the federal deficit. Without it, the much-needed decline in the dollar and improvement in trade will be difficult to achieve. However, a drastic deficit reduction package such as the one proposed by Senators Gramm, Rudman, and Hollings would bring the economy to its knees if it were not offset by substantial easing of monetary policy and a dramatic turnaround in trade.

A recurring theme in my comments this morning is that the increasing openness of the U.S. economy has changed the impact of fiscal policy on the economy and the ground rules for the conduct of policy. This means that U.S. history may be a poor guide for where we are headed and what we should do. Instead, we may learn something from studying the successes and failures of economic policy in countries with even more open economies.

OUTLOOK: SLOW GROWTH BUT NO RECESSION

History has little to reveal about when the next cyclical downturn will occur.

- Three of the seven postwar expansions in the United States ended before the fourth year; two ended in the fourth year; and two survived at least a fifth year.
- The shortest recovery was the 12-month expansion after the credit crunch of 1980. The longest recovery, in the 1960s, lasted 35 quarters.

Thus there is a reasonably good chance that the current recovery will last another year and a half. Nevertheless, the range of cycle lengths is broad.

There is uncertainty about when this expansion will end, but we can be sure of how it will end--or rather, how it will not end. Recoveries in the U.S. economy rarely die of old age. They die because of a shock to the economy, or because fiscal or monetary policy becomes restrictive. As a recovery matures, imbalances appear (such as excessive inventory accumulation and inflationary pressures) and constraints occur (such as credit squeezes). These tend to slow growth, but they don't usually bring on a recession. More often than not, it is policy reaction, or overreaction, to these imbalances or constraints that pushes the economy over the brink.

There are two types of constraints to growth: physical and financial.

Are there currently physical constraints to U.S. growth? The answer is a resounding no.

- Capacity utilization has remained low in this recovery. The current high levels of manufactured imports effectively mean that capacity is being imported into the United States.
- The unemployment rate has remained close to 7% and is not expected to decline much over the next year. The labor pressures and wage inflation that typically appear in the mature phases of a business cycle will not be seen in the near future.
- Businesses have kept their inventories very lean in the current recovery, and the inventory-to-sales ratio remains quite low relative to past peaks.

Clearly, U.S. growth is not being curtailed by physical constraints. But what about financial constraints? Here, the answer is somewhat more complex.

- The personal saving rate has dropped in recent months, and the ratio of consumer debt to disposable income has risen rapidly. Consumers may become very cautious in their spending over the next year as they try to bring their finances into line.
- The outlook for business savings has worsened because the profits outlook is turning decidedly less optimistic and uncertainty is increasing over the future of tax writeoffs.
- The federal deficit continues to be the biggest potential financial constraint in the economy. It uses up almost a quarter of total savings. The deficit's impact on growth would be far worse were it not for the record capital inflows that have come into the United States. Directly or indirectly these inflows have financed about half the federal deficit. They have also been available for private capital expenditures.

Whether or not U.S. growth will be reduced by financial constraints depends heavily on the future course of financial capital flows. However, it also depends on monetary policy. The Federal Reserve System's continued willingness to allow interest rates to drift down will soften the impact of any financial constraints that might develop. Most likely, there will not be a rapid flight of capital from the United States and, given the low rate of U.S. inflation, the Fed will continue to err on the side of monetary ease. For the moment at least, the Fed has no reason whatsoever to allow the U.S. economy to drift into a recession.

The lack of physical constraints to growth and the likelihood that no serious financial constraints will develop suggest that the United States is not poised on the brink of a recession. In other words, a recession is unlikely in the immediate future unless the recovery dies because of an outside shock for a policy mistake.

We should not become complacent about the inherent weakness in the U.S. economy, however.

- Consumer spending will slow over the next year, despite low rates of inflation, as consumers adjust to mounting debt burdens.
- Growth in investment spending, while still relatively strong, will slow because of the slack in the economy and the weakening outlook for cash flow.
- Interest rates will sustain reasonably high levels of housing sales and construction, but uncertainty over the outcome of tax reform and tightened mortgage eligibility requirements will preclude a housing boom.
- Despite recent declines, the high value of the dollar means that net exports will sap even more strength from the economy next year before they turn around.
- High rates of manufacturing unemployment could spill over into the service sector through weaker income growth.

These sources of weakness will not bring about a sharp and sustained decline in growth. Instead, growth will remain modest. Wharton projects that over the next 10 years, real growth will average under 3% (see Table 1). Inflation will also remain low, averaging less than the projections of the Congressional Budget Office or the Administration (see Table 2). Wharton's outlook for inflation and interest rates are also less optimistic. As a result, in Wharton's view the current law deficit will remain in the neighborhood of $200 billion for many years.

Table 1
Selected Indicators:
10-Year Average Annual Growth Rates
(Percent)

	1955-65	1965-75	1975-85	1985-95
Population	1.6	1.1	1.1	0.9
Civilian Labor Force	1.4	2.3	2.1	1.4
Employment	1.4	1.9	2.2	1.5
Productivity, All Industries	2.1	0.9	0.9	1.3
Productivity, Manufacturing	2.9	1.9	2.7	3.6
Real GNP	3.5	2.9	3.2	2.8
Real per Capita GNP	1.9	1.8	2.1	1.9
GNP Implicit Price Deflator	2.0	5.4	6.3	4.6
Real Disposable Income	3.7	3.6	3.2	2.7
Real per Capita Disposable Income	2.1	2.5	2.1	1.8
Wages Rates, All Industries	4.4	6.9	7.2	6.1

Table 2
Economic and Budget Projections:
The Administration, Congressional Budget Office, and Wharton Econometrics

	1985	1986	1987	1988	1989	1990
Real GNP (% Change)						
Administration	2.7	4.2	4.0	4.0	3.9	3.6
CBO	3.3	3.4	3.4	3.5	3.5	3.5
Wharton	2.5	2.8	3.3	2.8	3.0	0.0
GNP Deflator (% Change)						
Administration	3.8	4.1	4.2	3.9	3.6	3.3
CBO	4.1	4.1	4.4	4.2	4.3	4.3
Wharton	3.8	4.0	4.4	4.9	5.1	5.4
Unemployment Rate (%)						
Administration	7.3	7.0	6.8	6.5	6.3	6.0
CBO	7.3	7.0	6.9	6.7	6.5	6.4
Wharton	7.3	7.4	7.2	7.2	7.1	8.0
Three-Month Treasury Bill Rate (%)						
Administration	7.6	7.5	7.0	5.9	5.1	5.0
CBO	7.9	7.4	7.3	7.2	7.2	7.2
Wharton	7.5	6.8	7.5	8.4	8.7	9.4
Federal Deficit (Billion $)*						
Administration	211	178	139	100	54	18
CBO	210	175	163	143	132	120
Wharton	188	193	193	196	197	211

*Administration and CBO projections--fiscal year, unified basis; Wharton projection--calendar year, national income accounts basis.

THE EFFECTS OF LARGE FEDERAL DEFICITS: A STRONG DOLLAR, A TWO-TIERED ECONOMY, AND A DEBTOR NATION

Both the strength in the early phases of the current recovery and the subsequent weakness in the U.S. economy can be traced either directly or indirectly to the record federal deficit. During much of the postwar era a burgeoning federal deficit on this scale would have crowded out domestic investment. This has not occurred. Instead, given the flexibility of exchange rates and the increased integration of the United States into the world economy, massive federal borrowing raised interest rates, attracted foreign investment, and became one of the root causes of a stronger dollar. This, in turn, stemmed exports and stimulated imports. Looking back at the sequence of events,

- o Inflation in the United States was brought down, in large part, by Federal Reserve actions in the early 1980s and by the depth of the 1980-82 recession when the unemployment rate hit 10.7% and reduced wage demands.

- o Real rates of return in the United States were raised by the 1981 tax cuts, especially by the Accelerated Cost Recovery System.

- o Low inflation, favorable rates of return, and a record federal deficit boosted growth in the economy. These factors, combined with the relative stability of the United States, made the United States a safe haven for investing.

- o Record amounts of capital came into the United States, contributing to a strong dollar. The United States did virtually nothing to dampen this rise.

- o The strength of the dollar kept inflation and interest rates low, and the resulting sustained growth further strengthened the dollar. At the same time, imports started to rise very rapidly and have gradually slowed growth.

- o Trading-partner countries have been helped by their exports to the United States, but they have seen large capital outflows. These funds were available for investment in the United States largely because these countries, especially the United Kingdom, Germany and Japan, have sharply reduced their consolidated government budgets.

The result has been the emergence of a two-tiered economy in the United States during the 1980s. The import-competing and export sectors have been hurt badly while the nontrading portions of the economy--specifically services, construction, and defense-related industries--have grown rapidly. This divergence is most obvious when one looks at the statistics on employment. Employment in manufacturing has been flat, but jobs have been growing briskly in the service sector. This dichotomy is also apparent when looking at inflation statistics. Inflation in traded goods (commodities, manufactured products, etc.) has been very low. Indeed, there has been some disinflation. On the other hand, inflation in nontraded goods and services has ranged from 5% to 7%. This split in the U.S. economy is likely to persist for some time to come.

Another consequence of the large budget and trade imbalances is the transformation of the United States from a creditor nation to a debtor nation. By the end of this year, the nation will be the largest borrower in the world financial system.

By 1990 U.S. borrowing could rise to $1 trillion a year. The interest payments on this debt could explode, pushing the current account deficit into the $200-300 billion range.

FUTURE RISKS: A SLOW ADJUSTMENT OR COLLAPSE?

Some have suggested that the U.S. budget and trade deficits have put such a strain on the world economy that it will inevitably collapse. In Wharton's view, these fundamental imbalances could unwind slowly if

- o the dollar declines in an orderly fashion and there is no flight of capital from the United States;
- o U.S. policymakers--especially the Fed--do not overreact to rises in inflation;
- o U.S. domestic demand remains strong; and
- o U.S. inflation remains low.

The first two of these assumptions have the largest associated risks. Perhaps the biggest risk is a freefall in the dollar. The fall would be accompanied by a drying of capital inflows into the United States. The result would be a rise in both inflation and interest rates. This would exacerbate financial strains brought on by farm problems and difficulties in thrift institutions.

So far, the Federal Reserve has given a higher priority to sustaining growth in the economy and easing financial strains than to fighting inflation. This has led to very rapid growth in the monetary aggregates. If inflation shows any signs of picking up, the Fed cannot be expected to stay on this course.

One way to interpret the recent Group of Five agreement on the dollar is that both risks have been reduced somewhat. The five nations have, in effect, committed themselves to bring about an orderly decline in the dollar. For its part, the Fed has implicitly agreed to bring U.S. interest rates down further, or at least to let them rise little in the near future.

The longer-run risks to the U.S. economy relate to the ballooning internal and external debt. If the entire federal debt were financed internally, interest rates would rise and private investment would be crowded out, affecting the economy's potential growth. However, more and more of this debt is being held by foreigners. There is nothing inherently wrong with importing capital if it is used for productive investment. Unfortunately, much of this foreign capital is being used to finance the deficit. Thus future claims on U.S. earnings by foreigners will be paid at the expense of lower living standards for U.S. citizens.

DEFICIT REDUCTION MUST BE THE TOP PRIORITY

The G-5 agreement on the dollar will amount to little if it is not accompanied by a reduction in the U.S. budget deficit and more stimulative policies by the trading partners. This means that a substantial reduction in the deficit is the key element to restoring equilibrium in the United States and abroad. Such action takes priority over tax reform unless the constraint of revenue neutrality can be removed from the tax reform discussion. Moreover, one of the flaws in the tax reform proposals presented so far is that they would all depress investment and hurt industries that have already suffered from the strength of the dollar.

Deficit reduction by itself, however, would not do much to improve the outlook for the U.S. economy. If it were coupled with monetary stimulation and if it resulted in substantial declines in the dollar, then the composition of GNP would shift away from government spending to exports and investment. This shift would provide the basis for sustained long-run growth.

An analysis of the Gramm-Rudman-Hollings proposals illustrates the above points.

- Cutting the deficit to zero in 1991 from the Wharton baseline, using only spending cuts and assuming no offsetting stimulus, brings the economy to a grinding halt, pushing the unemployment rate up to 17% (see Figure 1).

- It is more realistic to assume that such a huge cut in the deficit would be accompanied by significant monetary easing and a sharper decline in the dollar. If the dollar fell an additional 24% and the Fed pushed up money supply growth by 3 to 4 percentage points more each year, then the unemployment rate would rise only to 9% by 1991.

Even with the additional stimulus from monetary policy and the decline in the dollar, there is no question that cutting the deficit to zero by 1991 will be a painful experience.

One of the major problems with legislating nominal targets for the deficit is that it does not allow the deficit to rise in recessions. For example, if a recession did occur in 1986, then attempting to hit the Gramm-Rudman-Hollings targets would push the unemployment rate up to 11.5% by 1987, thus prolonging the recession (see Figure 2).

There are more flexible ways of reducing the deficit that would not have such a pro-cyclical bias. For example, the target could be a reduction in the structural deficit to zero by 1991. Congress would have to agree on an appropriate measure of the structural deficit.

The deficit could also be reduced by raising revenues. Sooner or later revenues will have to find their way back to the bargaining table. The damage being done by the deficit is far greater than the possible problems created by a well-designed tax increase. One candidate for additional revenues might be a fee on imported oil. This would reduce both the trade and the federal deficits. Because of the expected softening in world oil prices over the next year, this would be a good time to consider

FIGURE 1: UNEMPLOYMENT RATE

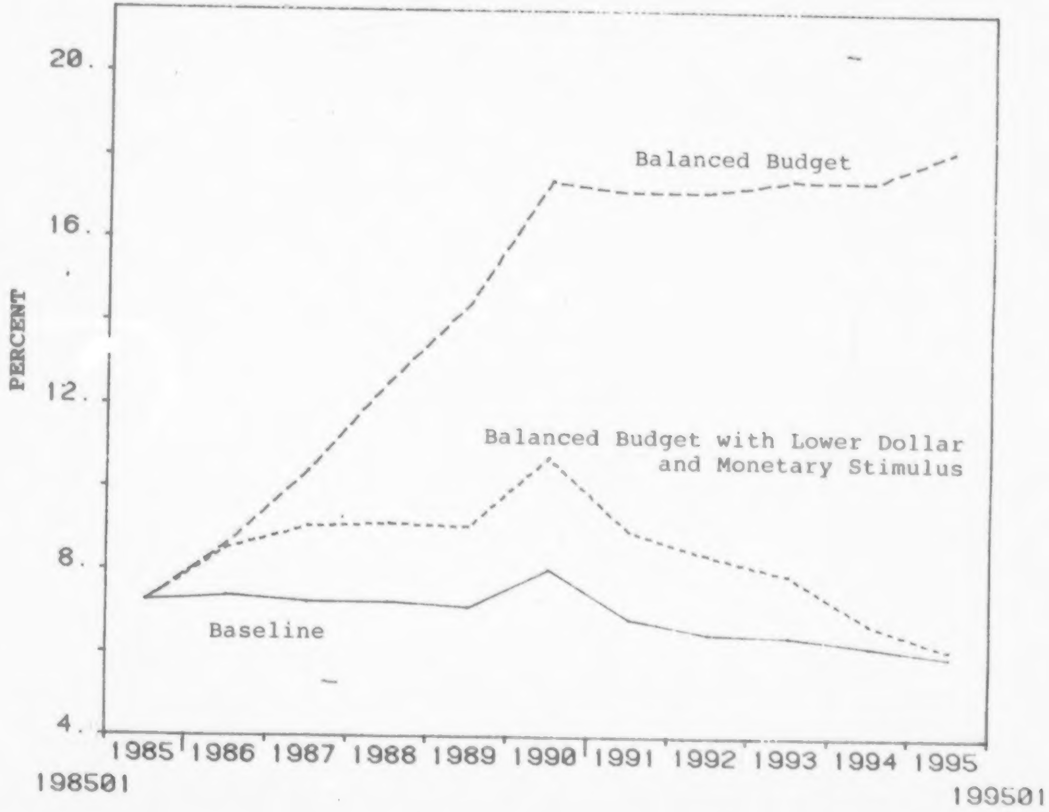
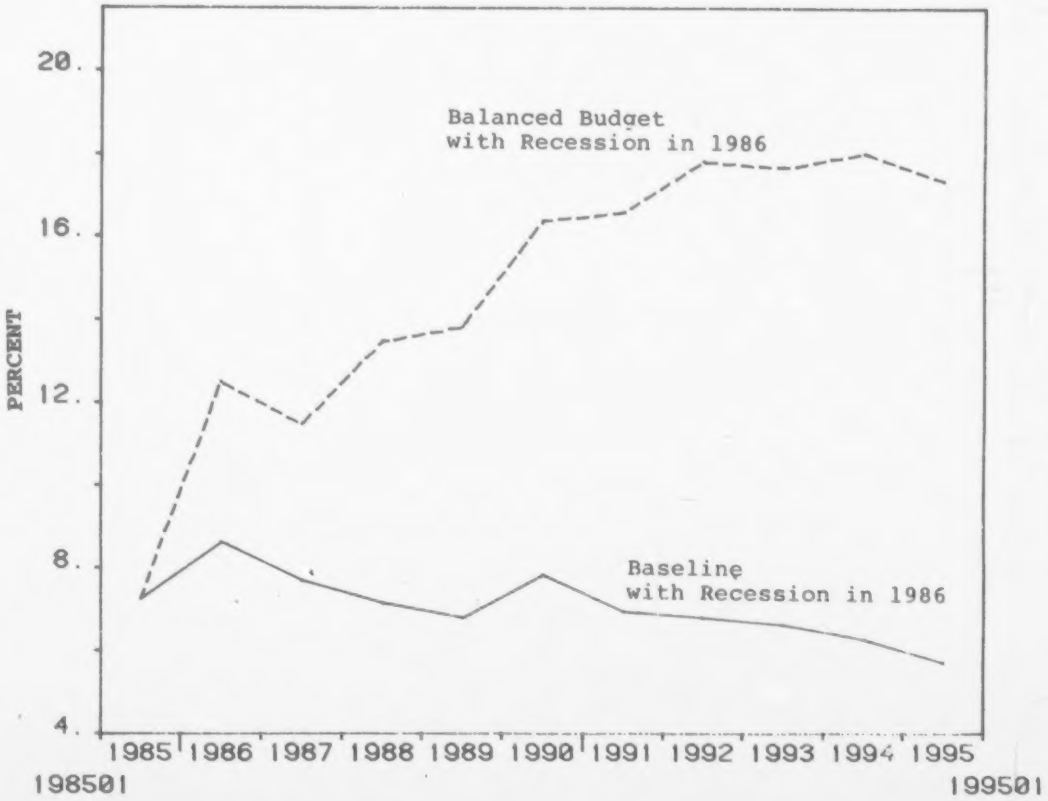


FIGURE 2: UNEMPLOYMENT RATE



implementing such a tax increase. In the past, an oil import fee has been opposed because it is regressive. In other words, it would have a negative impact on low-income families. These families could be compensated, however, without hampering the positive economic effects of the levy.

GREATER POLICY COORDINATION IS NEEDED WITH U.S. TRADING PARTNERS

The effectiveness of deficit reduction in the United States needs to be viewed in the context of worldwide policy realignment. When exchange rates can fluctuate freely, all parties pay a heavy price if one country maintains a stimulative fiscal policy while its trading partners do not. Stimulative fiscal policy in the United States has precipitated a rapid decline in U.S. competitiveness. Europe and Japan, in part because of their very conservative policies, have seen large capital outflows that have exacerbated the stagnation of their economies. The Europeans and Japanese would like the United States to reduce fiscal stimulation. The United States, on the other hand, would like to see these countries stimulate their economies into faster growth. The Europeans and Japanese are beginning to come to grips with a need for greater policy coordination. The G-5 agreement is the first step in this direction.

In a world of flexible exchange rates, U.S. growth rates will converge toward those of the trading partners, either because of trade leakage or because of conscious efforts to reduce fiscal stimulus. If the reduction is coordinated with a concerted effort to stimulate economic growth in Europe and Japan, then the badly needed international adjustments can occur in an orderly fashion.

THE WHARTON LONG-TERM MODEL
BASELINE AND FEDERAL BUDGET BALANCED

TABLE 1.00 SELECTED INDICATORS

		1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
GNP$	GROSS NATIONAL PRODUCT (CUR $)											
	FEDERAL BUDGET BALANCED	3895	4048	4187	4277	4353	4270	4466	4618	4776	5021	5200
	BASELINE	3895	4164	4491	4841	5239	5521	6024	6472	6945	7489	8108
	DIFFERENCE	0	-116	-304	-564	-886	-1251	-1558	-1854	-2169	-2467	-2908
	% DIFF	0	-3	-7	-12	-17	-23	-26	-29	-31	-33	-36
RGNP$	% CHANGE											
	FEDERAL BUDGET BALANCED	6.3	3.9	3.4	2.1	1.8	-1.9	4.6	3.4	3.4	5.1	3.6
	BASELINE	6.3	6.9	7.9	7.8	8.2	5.4	9.1	7.4	7.3	7.8	8.3
	DIFFERENCE	.0	-3.0	-4.4	-5.6	-6.4	-7.3	-4.5	-4.0	-3.9	-2.7	-4.7
	% DIFF	.0	-43.1	-56.3	-72.4	-78.3	-135.0	-49.8	-54.0	-53.2	-34.4	-56.9
GNP	GROSS NATIONAL PRODUCT (72 $)											
	FEDERAL BUDGET BALANCED	1679.7	1681.3	1686.5	1685.2	1693.9	1646.3	1742.4	1801.5	1840.3	1896.1	1910.5
	BASELINE	1679.7	1725.9	1782.6	1832.5	1887.1	1886.3	1987.6	2049.6	2101.5	2162.2	2224.2
	DIFFERENCE	.0	-44.6	-96.1	-147.3	-193.2	-239.9	-245.2	-248.2	-261.2	-266.1	-313.7
	% DIFF	.0	-2.6	-5.4	-8.0	-10.2	-12.7	-12.3	-12.1	-12.4	-12.3	-14.1
RGNP	% CHANGE											
	FEDERAL BUDGET BALANCED	2.5	.1	.3	-.1	.5	-2.8	5.8	3.4	2.2	3.0	.8
	BASELINE	2.5	2.8	3.3	2.8	3.0	.0	5.4	3.1	2.5	2.9	2.9
	DIFFERENCE	.0	-2.7	-3.0	-2.9	-2.5	-2.8	.5	.3	-.4	.1	-2.1
	% DIFF	.0	-96.6	-90.7	-102.7	-82.6	6306.8	8.5	8.7	-14.8	5.0	-73.5
PDGNP	GROSS NAT. PROD. DEFL. (1972=100.0)											
	FEDERAL BUDGET BALANCED	231.9	240.8	248.2	253.8	257.0	259.4	256.3	256.4	259.5	264.8	272.2
	BASELINE	231.9	241.2	251.9	264.2	277.6	292.7	303.1	315.8	330.5	346.3	364.5
	DIFFERENCE	.0	-.5	-3.7	-10.4	-20.6	-33.3	-46.8	-59.4	-70.9	-81.5	-92.3
	% DIFF	.0	-.2	-1.5	-3.9	-7.4	-11.4	-15.4	-18.8	-21.5	-23.5	-25.3
RPDGNP	% CHANGE											
	FEDERAL BUDGET BALANCED	3.8	3.8	3.1	2.2	1.3	.9	-1.2	.0	1.2	2.0	2.8
	BASELINE	3.8	4.0	4.4	4.9	5.1	5.4	3.5	4.2	4.7	4.8	5.2
	DIFFERENCE	.0	-.2	-1.3	-2.6	-3.8	-4.5	-4.7	-4.2	-3.4	-2.8	-2.5
	% DIFF	.0	-5.2	-29.7	-54.2	-75.3	-82.7	-133.6	-99.4	-73.5	-57.5	-47.1
NPT	POPULATION (MILLIONS)											
	FEDERAL BUDGET BALANCED	240.03	242.45	244.86	247.26	249.64	251.99	254.19	256.36	258.50	260.60	262.67
	BASELINE	240.03	242.45	244.86	247.26	249.64	251.99	254.19	256.36	258.50	260.60	262.67
	DIFFERENCE	.00	.00	.00	.00	.00	.00	.00	.00	.00	.00	.00
	% DIFF	.00	.00	.00	.00	.00	.00	.00	.00	.00	.00	.00
NPT	% CHANGE											
	FEDERAL BUDGET BALANCED	1.0	1.0	1.0	1.0	1.0	.9	.9	.9	.8	.8	.8
	BASELINE	1.0	1.0	1.0	1.0	1.0	.9	.9	.9	.8	.8	.8
	DIFFERENCE	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0
	% DIFF	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0
NLC	LABOR FORCE (MILLIONS)											
	FEDERAL BUDGET BALANCED	115.41	117.37	119.65	121.25	122.54	123.26	124.39	125.28	126.26	127.32	128.51
	BASELINE	115.41	117.33	119.66	121.45	123.14	124.42	126.17	127.71	129.28	130.85	132.44
	DIFFERENCE	.00	.04	-.01	-.20	-.60	-1.15	-1.78	-2.43	-3.02	-3.53	-3.93
	% DIFF	.00	.03	-.01	-.16	-.49	-.93	-1.41	-1.90	-2.34	-2.70	-2.97

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                                      THE WHARTON LONG-TERM MODEL
                                  BASELINE AND FEDERAL BUDGET BALANCED

                                     TABLE 1.00 SELECTED INDICATORS
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 |              |                                      |  1985    1986    1987    1988    1989    1990    1991    1992    1993    1994    1995|
-----------------------------------------------------------------------------------------------------------------------
 1|NLC          |                              % CHANGE|                                                                                     |
 2|             |FEDERAL BUDGET BALANCED-------------|    1.6     1.7     1.9     1.3     1.1      .6      .9      .7      .8      .8      .9|
 3|             |BASELINE----------------------------|    1.6     1.7     2.0     1.5     1.4     1.0     1.4     1.2     1.2     1.2     1.2|
 4|             |DIFFERENCE--------------------------|     .0      .0      .0     -.2     -.3     -.4     -.5     -.5     -.5     -.4     -.3|
 5|             |% DIFF------------------------------|     .0     2.0    -2.2   -10.4   -23.6   -43.0   -35.0   -41.3   -36.5   -30.8   -23.1|
 6|             |                                    |                                                                                     |
 7|NRLC*        |PARTICIPATION RATE------------------|                                                                                     |
 8|             |FEDERAL BUDGET BALANCED-------------|   64.3    64.7    65.2    65.4    65.4    65.1    65.1    64.9    64.8    64.8    64.7|
 9|             |BASELINE----------------------------|   64.3    64.7    65.2    65.5    65.7    65.7    66.0    66.2    66.4    66.6    66.7|
10|             |DIFFERENCE--------------------------|     .0      .0      .0     -.1     -.3     -.6     -.9    -1.3    -1.6    -1.8    -2.0|
11|             |% DIFF------------------------------|     .0      .0      .0     -.2     -.5     -.9    -1.4    -1.9    -2.3    -2.7    -3.0|
12|NRLC*        |                            % CHANGE|                                                                                     |
13|             |FEDERAL BUDGET BALANCED-------------|      0       1       1       0       0       0       0       0       0       0       0|
14|             |BASELINE----------------------------|      0       1       1       0       0       0       0       0       0       0       0|
15|             |DIFFERENCE--------------------------|      0       0       0       0       0       0       0       0       0       0       0|
16|             |% DIFF------------------------------|      0       6      -5     -37     -94   -4005    -112    -199    -163    -143    -104|
17|             |                                    |                                                                                     |
18|NEMT         |EMPLOYMENT (MILLIONS)---------------|                                                                                     |
19|             |FEDERAL BUDGET BALANCED-------------| 107.03  107.23  107.19  106.02  104.85  101.79  103.07  103.76  104.19  105.11  105.14|
20|             |BASELINE----------------------------| 107.03  108.67  111.02  112.66  114.39  114.41  117.52  119.39  120.97  122.71  124.52|
21|             |DIFFERENCE--------------------------|    .00   -1.44   -3.84   -6.64   -9.54  -12.62  -14.45  -15.63  -16.78  -17.61  -19.38|
22|             |% DIFF------------------------------|    .00   -1.33   -3.46   -5.89   -8.34  -11.03  -12.30  -13.09  -13.87  -14.35  -15.56|
23|NEMT         |                            % CHANGE|                                                                                     |
24|             |FEDERAL BUDGET BALANCED-------------|      2       0       0      -1      -1      -3       1       1       0       1       0|
25|             |BASELINE----------------------------|      2       2       2       1       2       0       3       2       1       1       1|
26|             |DIFFERENCE--------------------------|      0      -1      -2      -3      -3      -3      -1      -1      -1      -1      -1|
27|             |% DIFF------------------------------|      0     -88    -102    -174    -172  -15278     -54     -58     -69     -39     -98|
28|             |                                    |                                                                                     |
29|WRC$         |WAGE RATE PER WEEK, ALL INDUSTRIES-|                                                                                     |
30|             |FEDERAL BUDGET BALANCED-------------|  418.2   434.9   441.1   446.2   449.2   452.9   446.8   450.1   461.3   477.0   494.8|
31|             |BASELINE----------------------------|  418.2   438.7   457.3   484.3   517.1   556.0   584.6   620.5   661.4   704.8   753.7|
32|             |DIFFERENCE--------------------------|     .0    -3.8   -16.2   -38.2   -67.9  -103.0  -137.8  -170.3  -200.1  -227.8  -259.0|
33|             |% DIFF------------------------------|     .0     -.9    -3.5    -7.9   -13.1   -18.5   -23.6   -27.5   -30.3   -32.3   -34.4|
34|WRC$         |                            % CHANGE|                                                                                     |
35|             |FEDERAL BUDGET BALANCED-------------|    5.1     4.0     1.4     1.1      .7      .8    -1.4      .7     2.5     3.4     3.7|
36|             |BASELINE----------------------------|    5.1     4.9     4.3     5.9     6.8     7.5     5.1     6.1     6.6     6.6     6.9|
37|             |DIFFERENCE--------------------------|     .0     -.9    -2.8    -4.8    -6.1    -6.7    -6.5    -5.4    -4.1    -3.2    -3.2|
38|             |% DIFF------------------------------|     .0   -18.3   -66.3   -80.7   -90.0   -88.9  -126.3   -87.9   -62.3   -48.3   -46.2|
39|             |                                    |                                                                                     |
40|GNPPP        |PRODUCTIVITY - ALL INDUSTRIES------|                                                                                     |
41|             |FEDERAL BUDGET BALANCED-------------| 15.694  15.679  15.734  15.895  16.156  16.173  16.904  17.362  17.663  18.040  18.171|
42|             |BASELINE----------------------------| 15.694  15.882  16.056  16.266  16.497  16.487  16.912  17.167  17.372  17.620  17.863|
43|             |DIFFERENCE--------------------------|   .000   -.203   -.322   -.371   -.342   -.313   -.008    .195    .291    .420    .308|
44|             |% DIFF------------------------------|   .000  -1.277  -2.004  -2.279  -2.071  -1.901   -.047   1.135   1.673   2.382   1.726|
45|GNPPP        |                            % CHANGE|                                                                                     |
46|             |FEDERAL BUDGET BALANCED-------------|     .5     -.1      .4     1.0     1.6      .1     4.5     2.7     1.7     2.1      .7|
47|             |BASELINE----------------------------|     .5     1.2     1.1     1.3     1.4     -.1     2.6     1.5     1.2     1.4     1.4|
48|             |DIFFERENCE--------------------------|     .0    -1.3     -.7     -.3      .2      .2     1.9     1.2      .5      .7     -.6|
49|             |% DIFF------------------------------|     .0  -107.9   -68.0   -21.8    15.2  -275.4    75.1    79.7    45.1    49.6   -47.1|
50|             |                                    |                                                                                     |
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THE WHARTON LONG-TERM MODEL
BASELINE AND FEDERAL BUDGET BALANCED

TABLE 1.00 SELECTED INDICATORS

		1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
XMFPP	PRODUCTIVITY - ALL MANUFACTURING											
	FEDERAL BUDGET BALANCED	20.625	20.850	21.569	22.480	23.523	24.176	25.832	27.311	28.444	29.484	30.076
	BASELINE	20.625	21.277	22.204	23.113	24.007	24.550	25.562	26.669	27.709	28.590	29.506
	DIFFERENCE	.000	-.428	-.635	-.633	-.484	-.375	.270	.642	.735	.894	.570
	% DIFF	.000	-2.011	-2.860	-2.739	-2.017	-1.526	1.056	2.408	2.653	3.128	1.933
RXMFPP	% CHANGE											
	FEDERAL BUDGET BALANCED	2.3	1.1	3.4	4.2	4.6	2.8	6.8	5.7	4.1	3.7	2.0
	BASELINE	2.3	3.2	4.4	4.1	3.9	2.3	4.1	4.3	3.9	3.2	3.2
	DIFFERENCE	.0	-2.1	-.9	.1	.8	.5	2.7	1.4	.2	.5	-1.2
	% DIFF	.0	-65.6	-20.8	3.2	19.9	22.6	66.3	32.2	6.4	15.0	-37.3
GNPPC	REAL PER CAPITA GNP (THOU 72 $)											
	FEDERAL BUDGET BALANCED	7.0	6.9	6.9	6.8	6.8	6.5	[illegible]	7.0	7.1	7.3	7.3
	BASELINE	7.0	7.1	7.3	7.4	7.6	7.5	7.8	8.0	8.1	8.3	8.5
	DIFFERENCE	.0	-.2	-.4	-.6	-.8	-1.0	-1.0	-1.0	-1.0	-1.0	-1.2
	% DIFF	.0	-2.6	-5.4	-8.0	-10.2	-12.7	-12.3	-12.1	-12.4	-12.3	-14.1
GNPPC	% CHANGE											
	FEDERAL BUDGET BALANCED	1.4	-.9	-.7	-1.0	-.4	-3.7	4.9	2.5	1.3	2.2	.0
	BASELINE	1.4	1.7	2.3	1.8	2.0	-1.0	4.5	2.2	1.7	2.1	2.1
	DIFFERENCE	.0	-2.6	-2.9	-2.8	-2.4	-2.7	.5	.3	-.4	.1	-2.1
	% DIFF	.0	-152.5	-130.1	-157.9	-122.0	280.4	10.2	12.0	-22.1	6.9	-101.7
YPD/NPT	REAL PER CAP DISP INC (THOU 72$)											
	FEDERAL BUDGET BALANCED	5.0	5.0	4.8	4.7	4.6	4.4	4.5	4.6	4.6	4.6	4.6
	BASELINE	5.0	5.1	5.2	5.3	5.4	5.4	5.6	5.7	5.8	5.9	6.0
	DIFFERENCE	.0	-.1	-.4	-.6	-.8	-1.0	-1.1	-1.1	-1.2	-1.2	-1.4
	% DIFF	.0	-2.9	-6.9	-10.9	-14.7	-18.7	-19.5	-19.9	-20.8	-21.1	-23.3
YPD/NPT	% CHANGE											
	FEDERAL BUDGET BALANCED	2	-1	-2	-3	-2	-5	2	2	1	1	-1
	BASELINE	2	2	2	2	2	0	3	2	2	2	2
	DIFFERENCE	0	-3	-4	-4	-4	-5	-1	-1	-1	0	-3
	% DIFF	0	-137	-220	-237	-228	1618	-33	-23	-63	-25	-171
CPUBT$	CORPORATE PROFITS BEFORE TAXES											
	FEDERAL BUDGET BALANCED	227.1	202.4	208.0	232.5	264.5	235.5	315.9	380.5	411.1	487.3	530.0
	BASELINE	227.1	232.3	258.7	297.4	340.3	316.1	377.4	428.5	457.1	527.0	607.9
	DIFFERENCE	.0	-29.9	-50.7	-64.9	-75.8	-80.6	-61.4	-48.0	-46.0	-39.8	-77.9
	% DIFF	.0	-12.9	-19.6	-21.8	-22.3	-25.5	-16.3	-11.2	-10.1	-7.5	-12.8
CPUBT$	% CHANGE											
	FEDERAL BUDGET BALANCED	-3.7	-10.9	2.8	11.8	13.8	-11.0	34.2	20.4	8.0	18.5	8.8
	BASELINE	-3.7	2.3	11.4	14.9	14.4	-7.1	19.4	13.5	6.7	15.3	15.3
	DIFFERENCE	.0	-13.2	-8.6	-3.2	-.7	-3.8	14.8	6.9	1.4	3.2	-6.6
	% DIFF	.0	-574.4	-75.6	-21.2	-4.6	54.0	76.2	50.9	20.4	21.1	-42.9
FRMCSAAA	MOODY'S CORP. BOND RATE, AAA RATED											
	FEDERAL BUDGET BALANCED	11.43	10.07	9.85	9.06	8.05	7.10	5.90	4.58	4.47	4.70	5.36
	BASELINE	11.43	10.26	10.51	10.54	10.65	10.91	10.62	9.77	9.66	9.46	9.65
	DIFFERENCE	.00	-.20	-.66	-1.48	-2.59	-3.81	-4.72	-5.19	-5.20	-4.76	-4.30
	% DIFF	.00	-1.91	-6.31	-14.05	-24.36	-34.91	-44.41	-53.17	-53.79	-50.35	-44.53

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THE WHARTON LONG-TERM MODEL
BASELINE AND FEDERAL BUDGET BALANCED

TABLE 1.00 SELECTED INDICATORS

		1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
FRMTB3MV	MARKET YIELD, 3 MONTH TREAS BILLS											
	FEDERAL BUDGET BALANCED	7.53	6.28	6.27	6.04	5.04	4.74	2.30	2.07	2.76	3.73	4.23
	BASELINE	7.53	6.77	7.53	8.42	8.65	9.45	7.24	6.93	7.19	7.39	7.66
	DIFFERENCE	.00	-.49	-1.26	-2.38	-3.61	-4.71	-4.94	-4.87	-4.43	-3.67	-3.43
	% DIFF	.00	-7.28	-16.73	-28.21	-41.74	-49.81	-68.28	-70.18	-61.63	-49.58	-44.76
FM2$	MONEY SUPPLY, M2 BASIS (CURRENT $)											
	FEDERAL BUDGET BALANCED	2474	2598	2675	2725	2774	2742	2848	2906	2984	3102	3191
	BASELINE	2474	2652	2831	3026	3259	3447	3759	3998	4269	4574	4900
	DIFFERENCE	0	-54	-156	-301	-486	-705	-912	-1092	-1285	-1471	-1709
	% DIFF	0	-2	-6	-10	-15	-20	-24	-27	-30	-32	-35
RFM2$	% CHANGE											
	FEDERAL BUDGET BALANCED	8.6	5.0	3.0	1.9	1.8	-1.2	3.9	2.1	2.7	4.0	2.9
	BASELINE	8.6	7.2	6.8	6.9	7.7	5.8	9.1	6.4	6.8	7.1	7.1
	DIFFERENCE	.0	-2.2	-3.8	-5.0	-5.9	-6.9	-5.2	-4.3	-4.1	-3.2	-4.3
	% DIFF	.0	-30.4	-55.9	-72.8	-76.9	-120.0	-57.3	-67.7	-60.6	-44.4	-60.0
NRUT	UNEMPLOYMENT RATE (%)											
	FEDERAL BUDGET BALANCED	7.26	8.64	10.41	12.56	14.43	17.42	17.14	17.18	17.48	17.45	18.19
	BASELINE	7.26	7.38	7.22	7.23	7.11	8.04	6.85	6.51	6.43	6.22	5.98
	DIFFERENCE	.00	1.26	3.20	5.32	7.33	9.37	10.29	10.67	11.05	11.23	12.20
	% DIFF	.00	17.03	44.32	73.60	103.14	116.56	150.04	163.82	171.81	180.53	203.87
YPDSAVR	SAVINGS RATE (%)											
	FEDERAL BUDGET BALANCED	4.33	4.10	3.26	2.67	2.00	.42	1.58	2.26	2.31	2.39	1.91
	BASELINE	4.33	4.81	4.98	5.33	5.43	5.05	5.65	5.99	6.18	6.25	6.42
	DIFFERENCE	.00	-.71	-1.72	-2.65	-3.43	-4.63	-4.07	-3.73	-3.87	-3.87	-4.51
	% DIFF	.00	-14.66	-34.55	-49.82	-63.22	-91.75	-71.98	-62.23	-62.57	-61.80	-70.28
GVSURPF$	SURPLUS OR DEFICIT, FEDERAL (CUR $)											
	FEDERAL BUDGET BALANCED	-187.7	-171.0	-135.0	-99.0	-63.0	-27.0	.0	.0	.0	.0	.0
	BASELINE	-187.7	-192.8	-193.4	-196.2	-197.1	-210.7	-196.8	-195.1	-206.4	-205.9	-210.9
	DIFFERENCE	.0	21.8	58.4	97.2	134.1	183.7	196.7	195.1	206.3	205.9	210.8
	% DIFF	.0	-11.3	-30.2	-49.5	-68.0	-87.2	-100.0	-100.0	-100.0	-100.0	-100.0
GVSURPS$	SURPLUS OR DEF, STATE & LOC (CUR $)											
	FEDERAL BUDGET BALANCED	51.5	36.1	34.4	35.5	39.9	24.3	53.8	76.6	87.8	103.9	110.5
	BASELINE	51.5	46.6	55.4	64.5	72.7	55.7	74.9	85.4	87.3	92.7	101.9
	DIFFERENCE	.0	-10.5	-21.1	-29.0	-32.8	-31.4	-21.1	-8.8	.5	11.2	8.6
	% DIFF	.0	-22.5	-38.0	-45.0	-45.1	-56.4	-28.2	-10.3	.6	12.1	8.4
WBC$/YN$	COMPEN. TO EMPLOYEES TO NAT. INCOME											
	FEDERAL BUDGET BALANCED	74.1	74.7	73.8	72.1	70.6	71.0	67.3	65.9	65.8	65.1	65.4
	BASELINE	74.1	73.9	73.2	72.5	72.4	74.0	72.8	73.0	73.5	73.5	73.6
	DIFFERENCE	.0	.8	.6	-.4	-1.8	-3.0	-5.5	-7.0	-7.7	-8.4	-8.3
	% DIFF	.0	1.1	.8	-.5	-2.5	-4.1	-7.5	-9.6	-10.5	-11.5	-11.2
CPABT$/YN$	PROFITS TO NATIONAL INCOME											
	FEDERAL BUDGET BALANCED	9.6	8.8	9.2	10.1	11.2	10.8	13.3	14.2	14.2	15.1	15.4
	BASELINE	9.6	9.3	9.5	9.6	9.7	8.5	9.5	9.5	9.2	9.5	9.7
	DIFFERENCE	.0	-.5	-.3	.5	1.5	2.3	3.8	4.7	5.1	5.7	5.7
	% DIFF	.0	-5.7	-2.7	5.3	15.7	27.3	39.8	49.3	55.4	60.1	59.2

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THE WHARTON LONG-TERM MODEL
BASELINE AND FEDERAL BUDGET BALANCED AND DOLLAR DECLINE AND MONETARY STIMULUS

TABLE 1.00 SELECTED INDICATORS

		1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
GNP$	GROSS NATIONAL PRODUCT (CUR $)											
	BUD. BAL., $ DEC., MONETARY STIM.	3895	4068	4347	4673	5025	5196	5760	6164	6665	7361	8021
	BASELINE	3895	4164	4491	4841	5239	5521	6024	6472	6945	7489	8108
	DIFFERENCE	0	-95	-143	-167	-213	-325	-264	-308	-280	-127	-87
	% DIFF	0	-2	-3	-3	-4	-6	-4	-5	-4	-2	-1
RGNP$	% CHANGE											
	BUD. BAL., $ DEC., MONETARY STIM.	6.3	4.5	6.9	7.5	7.5	3.4	10.9	7.0	8.1	10.4	9.0
	BASELINE	6.3	6.9	7.9	7.8	8.2	5.4	9.1	7.4	7.3	7.8	8.3
	DIFFERENCE	.0	-2.4	-1.0	-.3	-.7	-2.0	1.8	-.4	.8	2.6	.7
	% DIFF	.0	-35.5	-12.7	-3.8	-8.4	-37.0	19.3	-5.8	11.3	33.3	8.5
GNP	GROSS NATIONAL PRODUCT (72 $)											
	BUD. BAL., $ DEC., MONETARY STIM.	1679.7	1688.3	1740.7	1801.5	1856.3	1829.6	1970.3	2028.8	2097.0	2197.1	2255.0
	BASELINE	1679.7	1725.9	1782.6	1832.5	1887.1	1886.3	1987.6	2049.6	2101.5	2162.2	2224.2
	DIFFERENCE	.0	-37.7	-41.9	-31.0	-30.8	-56.7	-17.3	-20.8	-4.5	34.9	30.8
	% DIFF	.0	-2.2	-2.3	-1.7	-1.6	-3.0	-.9	-1.0	-.2	1.6	1.4
RGNP	% CHANGE											
	BUD. BAL., $ DEC., MONETARY STIM.	2.5	.5	3.1	3.5	3.0	-1.4	7.7	3.0	3.4	4.8	2.6
	BASELINE	2.5	2.8	3.3	2.8	3.0	.0	5.4	3.1	2.5	2.9	2.9
	DIFFERENCE	.0	-2.2	-.2	.7	.1	-1.4	2.3	-.2	.8	1.9	-.2
	% DIFF	.0	-81.5	-5.3	24.6	2.3	3186.0	43.2	-4.9	32.9	65.2	-8.1
PDGNP	GROSS NAT. PROD. DEFL. (1972=100.0)											
	BUD. BAL., $ DEC., MONETARY STIM.	231.9	241.0	249.7	259.4	270.7	284.0	292.4	303.8	317.8	335.0	355.7
	BASELINE	231.9	241.2	251.9	264.2	277.6	292.7	303.1	315.8	330.5	346.3	364.5
	DIFFERENCE	.0	-.3	-2.2	-4.7	-6.9	-8.7	-10.7	-11.9	-12.6	-11.3	-8.8
	% DIFF	.0	-.1	-.9	-1.8	-2.5	-3.0	-3.5	-3.8	-3.8	-3.3	-2.4
RPDGNP	% CHANGE											
	BUD. BAL., $ DEC., MONETARY STIM.	3.8	3.9	3.6	3.9	4.3	4.9	2.9	3.8	4.6	5.4	6.2
	BASELINE	3.8	4.0	4.4	4.9	5.1	5.4	3.5	4.2	4.7	4.8	5.2
	DIFFERENCE	.0	-.1	-.8	-1.0	-.7	-.5	-.6	-.3	.0	.6	.9
	% DIFF	.0	-2.8	-17.8	-20.3	-14.5	-9.8	-16.9	-6.3	-.9	12.7	17.5
NPT	POPULATION (MILLIONS)											
	BUD. BAL., $ DEC., MONETARY STIM.	240.03	242.45	244.86	247.26	249.64	251.99	254.19	256.36	258.50	260.60	262.67
	BASELINE	240.03	242.45	244.86	247.26	249.64	251.99	254.19	256.36	258.50	260.60	262.67
	DIFFERENCE	.00	.00	.00	.00	.00	.00	.00	.00	.00	.00	.00
	% DIFF	.00	.00	.00	.00	.00	.00	.00	.00	.00	.00	.00
NPT	% CHANGE											
	BUD. BAL., $ DEC., MONETARY STIM.	1.0	1.0	1.0	1.0	1.0	.9	.9	.9	.8	.8	.8
	BASELINE	1.0	1.0	1.0	1.0	1.0	.9	.9	.9	.8	.8	.8
	DIFFERENCE	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0
	% DIFF	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0
NL	LABOR FORCE (MILLIONS)											
	BUD. BAL., $ DEC., MONETARY STIM.	115.41	117.39	119.59	121.17	122.70	123.91	125.52	126.98	128.48	130.07	131.75
	BASELINE	115.41	117.33	119.66	121.45	123.14	124.42	126.17	127.71	129.28	130.85	132.44
	DIFFERENCE	.00	.06	-.07	-.27	-.44	-.51	-.66	-.73	-.80	-.78	-.69
	% DIFF	.00	.05	-.06	-.23	-.36	-.41	-.52	-.57	-.62	-.60	-.52

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THE WHARTON LONG-TERM MODEL
BASELINE AND FEDERAL BUDGET BALANCED AND DOLLAR DECLINE AND MONETARY STIMULUS

TABLE 1.00 SELECTED INDICATORS

		1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
NLC	% CHANGE											
	BUD. BAL., $ DEC., MONETARY STIM.--	1.6	1.7	1.9	1.3	1.3	1.0	1.3	1.2	1.2	1.2	1.3
	BASELINE----------------------	1.6	1.7	2.0	1.5	1.4	1.0	1.4	1.2	1.2	1.2	1.2
	DIFFERENCE--------------------	.0	.0	-.1	-.2	-.1	-.1	-.1	-.1	.0	.0	.1
	% DIFF------------------------	.0	2.9	-5.6	-11.3	-9.5	-5.0	-8.1	-4.5	-3.8	1.9	6.3
NRLC*	PARTICIPATION RATE----------------											
	BUD. BAL., $ DEC., MONETARY STIM.--	64.3	64.7	65.2	65.4	65.5	65.5	65.7	65.8	66.0	66.2	66.4
	BASELINE----------------------	64.3	64.7	65.2	65.5	65.7	65.7	66.0	66.2	66.4	66.6	66.7
	DIFFERENCE--------------------	.0	.0	.0	-.1	-.2	-.3	-.3	-.4	-.4	-.4	-.3
	% DIFF------------------------	.0	.0	-.1	-.2	-.4	-.4	-.5	-.6	-.6	-.6	-.5
NRLC*	% CHANGE											
	BUD. BAL., $ DEC., MONETARY STIM.--	0	1	1	0	0	0	0	0	0	0	0
	BASELINE----------------------	0	1	1	0	0	0	0	0	0	0	0
	DIFFERENCE--------------------	0	0	0	0	0	0	0	0	0	0	0
	% DIFF------------------------	0	9	-13	-40	-38	-466	-26	-22	-17	9	28
NEP	EMPLOYMENT (MILLIONS)--------------											
	BUD. BAL., $ DEC., MONETARY STIM.--	107.03	107.37	108.73	110.08	111.57	110.60	114.25	116.30	118.31	121.29	123.65
	BASELINE----------------------	107.03	108.67	111.02	112.66	114.39	114.41	117.52	119.39	120.97	122.71	124.52
	DIFFERENCE--------------------	.00	-1.30	-2.29	-2.58	-2.82	-3.81	-3.27	-3.09	-2.66	-1.42	-.87
	% DIFF------------------------	.00	-1.20	-2.06	-2.29	-2.46	-3.33	-2.78	-2.59	-2.20	-1.16	-.70
NEP	% CHANGE											
	BUD. BAL., $ DEC., MONETARY STIM.--	2	0	1	1	1	-1	3	2	2	3	2
	BASELINE----------------------	2	2	2	1	2	0	3	2	1	1	1
	DIFFERENCE--------------------	0	-1	-1	0	0	-1	1	0	0	1	0
	% DIFF------------------------	0	-79	-41	-16	-12	-4634	21	. 13	31	75	32
WRL$	WAGE RATE PER WEEK, ALL INDUSTRIES-											
	BUD. BAL., $ DEC., MONETARY STIM.--	418.2	436.1	449.1	470.3	499.2	532.9	557.3	591.5	633.8	684.0	742.6
	BASELINE----------------------	418.2	438.7	457.3	484.3	517.1	556.0	584.6	620.5	661.4	704.8	753.7
	DIFFERENCE--------------------	.0	-2.6	-8.3	-14.0	-17.9	-23.0	-27.3	-29.0	-27.7	-20.8	-11.1
	% DIFF------------------------	.0	-.6	-1.8	-2.9	-3.5	-4.1	-4.7	-4.7	-4.2	-2.9	-1.5
WRL$	% CHANGE											
	BUD. BAL., $ DEC., MONETARY STIM.--	5.1	4.3	3.0	4.7	6.1	6.7	4.6	6.1	7.1	7.9	8.6
	BASELINE----------------------	5.1	4.9	4.3	5.9	6.8	7.5	5.1	6.1	6.6	6.6	6.9
	DIFFERENCE--------------------	.0	-.6	-1.3	-1.2	-.6	-.8	-.6	.0	.5	1.4	1.6
	% DIFF------------------------	.0	-12.6	-30.1	-19.8	-9.2	-10.1	-11.2	-.1	8.2	21.0	23.3
GNPPP	PRODUCTIVITY - ALL INDUSTRIES------											
	BUD. BAL., $ DEC., MONETARY STIM.--	15.694	15.724	16.009	16.365	16.638	16.543	17.245	17.444	17.724	18.114	18.237
	BASELINE----------------------	15.694	15.882	16.056	16.266	16.497	16.487	16.912	17.167	17.372	17.620	17.863
	DIFFERENCE--------------------	.000	-.158	-.047	.100	.141	.056	.333	.277	.352	.494	.374
	% DIFF------------------------	.000	-.995	-.292	.612	.856	.340	1.969	1.613	2.027	2.804	2.096
GNPPP	% CHANGE											
	BUD. BAL., $ DEC., MONETARY STIM.--	.5	.2	1.8	2.2	1.7	-.6	4.2	1.2	1.6	2.2	.7
	BASELINE----------------------	.5	1.2	1.1	1.3	1.4	-.1	2.6	1.5	1.2	1.4	1.4
	DIFFERENCE--------------------	.0	-1.0	.7	.9	.2	-.5	1.7	-.4	.4	.8	-.7
	% DIFF------------------------	-.1	-84.0	65.7	70.2	17.2	811.9	64.6	-23.5	34.5	54.2	-50.7

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TABLE 1.00 SELECTED INDICATORS

		1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
AMFPP	PRODUCTIVITY - ALL MANUFACTURING---											
	BUD. BAL., $ DEC., MONETARY STIM.--	20 625	20.950	22.144	23.341	24.188	24.411	25.931	26.747	27.823	28.892	29.408
	BASELINE-----	20.625	21.277	22.204	23.113	24.007	24.550	25.562	26.669	27.709	28.590	29.506
	DIFFERENCE-----	.000	-.327	-.060	.227	.181	-.139	.370	.078	.114	.302	-.098
	% DIFF-----	-.001	-1.537	-.271	.983	.753	-.567	1.447	.292	.412	1.058	-.332
RAMFPP	% CHANGE											
	BUD. BAL., $ DEC., MONETARY STIM.--	2.3	1.6	5.7	5.4	3.6	.9	6.2	3.1	4.0	3.8	1.8
	BASELINE-----	2.3	3.2	4.4	4.1	3.9	2.3	4.1	4.3	3.9	3.2	3.2
	DIFFERENCE-----	.0	-1.6	1.3	1.3	-.2	-1.3	2.1	-1.2	.1	.7	-1.4
	% DIFF-----	.0	-50.1	30.8	31.9	-6.1	-59.2	51.2	-27.4	3.2	20.9	-44.3
GNPPC	REAL PER CAPITA GNP (THOU 72 $)----											
	BUD. BAL., $ DEC., MONETARY STIM.--	7.0	7.0	7.1	7.3	7.4	7.3	7.8	7.9	8.1	8.4	8.6
	BASELINE-----	7.0	7.1	7.3	7.4	7.6	7.5	7.8	8.0	8.1	8.3	8.5
	DIFFERENCE-----	.0	-.2	-.2	-.1	-.1	-.2	-.1	-.1	.0	.1	.1
	% DIFF-----	.0	-2.2	-2.3	-1.7	-1.6	-3.0	-.9	-1.0	-.2	1.6	1.4
GNPPC	% CHANGE											
	BUD. BAL., $ DEC., MONETARY STIM.--	1.4	-.5	2.1	2.5	2.1	-2.4	6.8	2.1	2.5	3.9	1.8
	BASELINE-----	1.4	1.7	2.3	1.8	2.0	-1.0	4.5	2.2	1.7	2.1	2.1
	DIFFERENCE-----	.0	-2.2	-.2	.7	.1	-1.4	2.3	-.2	.8	1.9	-.2
	% DIFF-----	.0	-128.7	-7.6	37.8	3.3	141.6	51.6	-6.8	49.0	90.8	-11.2
YPD/NPT	REAL PER CAP DISP INC (THOU 72$)---											
	BUD. BAL., $ DEC., MONETARY STIM.--	5.0	5.0	5.0	5.0	5.1	5.0	5.2	5.4	5.5	5.7	5.9
	BASELINE-----	5.0	5.1	5.2	5.3	5.4	5.4	5.6	5.7	5.8	5.9	6.0
	DIFFERENCE-----	.0	-.2	-.3	-.3	-.3	-.4	-.3	-.3	-.3	-.2	-.1
	% DIFF-----	.0	-3.1	-4.9	-5.3	-5.7	-7.6	-6.0	-5.7	-4.8	-2.7	-2.1
YPD/NPT	% CHANGE											
	BUD. BAL., $ DEC., MONETARY STIM.--	2	-1	0	1	1	-2	5	3	3	4	2
	BASELINE-----	2	2	2	2	2	0	3	2	2	2	2
	DIFFERENCE-----	0	-3	-2	0	0	-2	2	0	1	2	1
	% DIFF-----	0	-143	-103	-22	-24	714	58	14	54	129	34
CPUBT$	CORPORATE PROFITS BEFORE TAXES-----											
	BUD. BAL., $ DEC., MONETARY STIM.--	227.1	206.1	242.3	295.2	331.3	281.5	385.6	410.0	438.9	538.3	572.7
	BASELINE-----	227.1	232.3	258.7	297.4	340.3	316.1	377.4	428.5	457.1	527.0	607.9
	DIFFERENCE-----	.0	-26.2	-16.4	-2.1	-9.1	-34.6	8.2	-18.5	-18.1	11.3	-35.2
	% DIFF-----	.0	-11.3	-6.4	-.7	-2.7	-10.9	2.2	-4.3	-4.0	2.1	-5.8
CPUBT$	% CHANGE											
	BUD. BAL., $ DEC., MONETARY STIM.--	-3.7	-9.2	17.6	21.9	12.2	-15.0	37.0	6.3	7.1	22.6	6.4
	BASELINE-----	-3.7	2.3	11.4	14.9	14.4	-7.1	19.4	13.5	6.7	15.3	15.3
	DIFFERENCE-----	.0	-11.5	6.2	6.9	-2.2	-7.9	17.6	-7.2	.4	7.3	-9.0
	% DIFF-----	.0	-502.5	54.2	46.2	-15.5	110.7	90.6	-53.3	5.8	47.9	-58.3
RAM$AAA	MOODY'S CORP. BOND RATE, AAA RATED-											
	BUD. BAL., $ DEC., MONETARY STIM.--	11.43	9.51	9.07	8.49	8.18	8.29	8.12	7.37	7.49	7.71	8.24
	BASELINE-----	11.43	10.26	10.51	10.54	10.65	10.91	10.62	9.77	9.66	9.46	9.65
	DIFFERENCE-----	.00	-.75	-1.45	-2.05	-2.47	-2.62	-2.50	-2.40	-2.17	-1.75	-1.42
	% DIFF-----	.00	-7.31	-13.77	-19.48	-23.17	-24.00	-23.54	-24.55	-22.47	-18.52	-14.67

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TABLE 1.00 SELECTED INDICATORS

		1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
FRMTB3MY	MARKET YIELD, 3 MONTH TREAS BILLS											
	BUD. BAL., $ DEC., MONETARY STIM.	7.53	4.88	5.46	6.13	6.25	6.95	5.27	4.88	5.48	6.33	6.72
	BASELINE	7.53	6.77	7.53	8.42	8.65	9.45	7.24	6.93	7.19	7.39	7.66
	DIFFERENCE	.00	-1.89	-2.07	-2.29	-2.40	-2.50	-1.97	-2.06	-1.71	-1.07	-.94
	% DIFF	.00	-27.90	-27.49	-27.18	-27.80	-26.45	-27.26	-29.70	-23.74	-14.44	-12.32
FM2$	MONEY SUPPLY, M2 BASIS (CURRENT $)											
	BUD. BAL., $ DEC., MONETARY STIM.	2474	2681	2830	3013	3226	3356	3687	3922	4206	4590	4967
	BASELINE	2474	2652	2831	3026	3259	3447	3759	3998	4269	4574	4900
	DIFFERENCE	0	29	0	-12	-33	-91	-72	-76	-63	16	67
	% DIFF	0	1	0	0	-1	-3	-2	-2	-1	0	1
RFM2$	% CHANGE											
	BUD. BAL., $ DEC., MONETARY STIM.	8.6	8.4	5.6	6.5	7.1	4.0	9.9	6.4	7.2	9.1	8.2
	BASELINE	8.6	7.2	6.8	6.9	7.7	5.8	9.1	6.4	6.8	7.1	7.1
	DIFFERENCE	.0	1.2	-1.2	-.4	-.7	-1.7	.8	.0	.5	2.0	1.1
	% DIFF	.0	16.6	-17.6	-6.1	-8.5	-30.0	8.9	.3	6.7	27.9	15.4
NRU*	UNEMPLOYMENT RATE (%)											
	BUD. BAL., $ DEC., MONETARY STIM.	7.26	8.54	9.08	9.15	9.07	10.74	8.97	8.41	7.92	6.75	6.15
	BASELINE	7.26	7.38	7.22	7.23	7.11	8.04	6.85	6.51	6.43	6.22	5.98
	DIFFERENCE	.00	1.16	1.86	1.92	1.97	2.70	2.12	1.89	1.49	.53	.17
	% DIFF	.00	15.66	25.77	26.56	27.66	33.58	30.91	29.09	23.09	8.54	2.78
YPDSAVR	SAVINGS RATE (%)											
	BUD. BAL., $ DEC., MONETARY STIM.	4.33	4.08	3.81	4.27	4.44	3.52	4.74	5.27	5.62	6.14	6.37
	BASELINE	4.33	4.81	4.98	5.33	5.43	5.05	5.65	5.99	6.18	6.25	6.42
	DIFFERENCE	.00	-.73	-1.17	-1.05	-.99	-1.53	-.91	-.72	-.56	-.12	-.05
	% DIFF	.01	-15.25	-23.50	-19.80	-18.17	-30.22	-16.09	-12.08	-9.02	-1.85	-.79
GVSURPF$	SURPLUS OR DEFICIT, FEDERAL (CUR $)											
	BUD. BAL., $ DEC., MONETARY STIM.	-187.7	-171.0	-135.0	-99.0	-63.0	-27.0	.0	.0	.0	.0	.0
	BASELINE	-187.7	-192.8	-193.4	-196.2	-197.1	-210.7	-196.8	-195.1	-206.4	-205.9	-210.9
	DIFFERENCE	.0	21.8	58.4	97.2	134.1	183.7	196.8	195.1	206.3	205.9	210.8
	% DIFF	.0	-11.3	-30.2	-49.5	-68.0	-87.2	-100.0	-100.0	-100.0	-100.0	-100.0
GVSURPS$	SURPLUS OR DEF, STATE & LOC (CUR $)											
	BUD. BAL., $ DEC., MONETARY STIM.	51.5	34.9	40.7	52.0	58.5	32.4	63.7	71.8	76.6	93.8	94.6
	BASELINE	51.5	46.6	55.4	64.5	72.7	55.7	74.9	85.4	87.3	92.7	101.9
	DIFFERENCE	.0	-11.7	-14.7	-12.6	-14.2	-23.3	-11.2	-13.5	-10.7	1.1	-7.3
	% DIFF	.0	-25.2	-26.6	-19.5	-19.5	-41.8	-15.0	-15.9	-12.2	1.2	-7.1
WBC$/YN$	COMPEN. TO EMPLOVEES TO NAT. INCOME											
	BUD. BAL., $ DEC., MONETARY STIM.	74.1	74.7	73.1	71.6	71.4	73.5	71.0	71.7	72.3	72.1	73.2
	BASELINE	74.1	73.9	73.2	72.5	72.4	74.0	72.8	73.0	73.5	73.5	73.6
	DIFFERENCE	.0	.7	.0	-.9	-.9	-.5	-1.8	-1.3	-1.2	-1.4	-.4
	% DIFF	.0	1.0	-.1	-1.2	-1.3	-.6	-2.5	-1.8	-1.7	-1.9	-.6
CPABT$/YN$	PROFITS TO NATIONAL INCOME											
	BUD. BAL., $ DEC., MONETARY STIM.	9.6	8.8	9.7	10.3	10.2	8.5	10.4	9.8	9.3	9.7	9.0
	BASELINE	9.6	9.3	9.5	9.6	9.7	8.5	9.5	9.5	9.2	9.5	9.7
	DIFFERENCE	.0	-.5	.2	.7	.5	.0	.9	.3	.2	.3	-.7
	% DIFF	.0	-5.3	1.9	7.3	5.8	.5	9.7	3.4	2.1	2.7	-6.8

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The **Chairman**. Thank you very much, Dr. Behravesh.

Let me ask you a question. As you look at Gramm-Rudman, in its current form, and we know it is being changed even as you testify before us, do you think that is a correct approach to trying to gain some control over the deficit and the increasing debt or do you feel that there are too many associated risks with that kind of approach and therefore should not be adopted by the Congress?

Mr. **Behravesh**. Let me echo both what you and Larry Chimerine, said, namely, I applaud the goals involved here, but I have trouble with the specific proposal itself in that it targets the nominal deficits in given years which are subject to wide fluctuations given changes in the economy.

My preference would be to go with some measure of structural deficit that would be reduced over a period of time. The problem is, as I mentioned, that if you get into a recessionary situation, it becomes especially hard to achieve those deficit targets without prolonging the recession, without plunging the economy further into a recessionary situation.

The **Chairman**. From the Wharton Econometric Forecasting point of view, do you see us being able to cut our way out of this deficit in the next 4 to 5 years, or do we have to have revenues?

Mr. **Behravesh**. I think it is extremely painful just going with spending cuts. It is an extremely painful way to approach the deficit problem.

My strong preference would be, as I said in my testimony, to also include revenue increases. One possible suggestion, as I mentioned, was an oil import fee which would have the positive effect of reducing both the trade and the Federal deficits.

The **Chairman**. As one who comes from the Northeast, that is where Wharton is located, there would be those who would argue that such an oil import fee would penalize the Frost Belt where you have so many home heating oil situations. How do you respond to that?

Mr. **Behravesh**. Well, I understand the argument. One of the issues here is that the oil prices have been declining quite a bit and our assessment is that there is a potential for them to decline quite a bit more. So it would be an issue of how much further would the decline in, let's say, gasoline prices, be. Would they go down, without an oil import fee? They may be going down another 20 cents, without a fee, but they could go down another 10 cents with a fee. It is a question of declines rather than necessarily a higher price.

But I understand the argument that clearly there are certain sectors of the economy and certain regions in the economy that would get hurt more by such a tax.

The **Chairman**. Would you make such a fee a permanent part of the revenue base or would you make it something that would be temporary?

Mr. **Behravesh**. Well, I don't think it necessarily has to be a permanent feature. I think we could impose it on a temporary basis until we got the Federal deficit down and then phase it out. That is certainly a possibility.

The **Chairman**. The reason I asked you that question is because as I look at the whole question of revenues as I said before, you are not going to have revenues on the table unless a President is willing to support revenues and states that out front, otherwise Congress is not going to even deal with the revenue question, simply because Speaker O'Neill has a lot of influence, Majority Leader Dole has a lot of influence, none of them carry a veto gun.

As a result, I have argued that you need the executive branch to put revenues on the table, the legislative branch to put a strong spending reduction and control package on the table, combined, and that the revenues should be from a dedicated source that goes only to deficit reduction, only to deficit reduction, doesn't go even into the proprietor's hands that can be utilized for any other program, or any kind of spending; and second, it would be temporary.

Two or three years and it would be automatically phased out, it would take a vote of the Congress and the signature of the President to make it part of the permanent revenue base and thus it would be also something that would not hurt investment incentives and as such I believe that the American people would support something like that if they knew that as a result of that you wouldn't have one of these quick-fix proposals, procedural proposals, but you could really demonstrate here is where we are going to be 3 years from now, and we could—in that case, 3 to 4 years from now, not 1991, but maybe even 1989—project a balance and in 1990, project even a surplus.

Is that the kind of thing that sounds feasible from your point of view?

Mr. BEHRAVESH. I want to emphasize a couple of points that you made. Clearly revenues have got to be on the table. I understand the politics of the situation and in the sense that the administration has to come to the table with them, but from an economics point of view, revenues are an essential ingredient of the solution. Whether they should be temporary or permanent, would depend on the kind of tax that was being proposed.

Something like oil import fee, whether you agree with it or not, certainly could be imposed on a temporary basis. But I want to emphasize that revenue increases have to be part of the solution.

I don't necessarily agree with the oil import fee, there may be some mechanisms that could be put in place with an oil import fee that would not penalize certain regions of the country, such as the Frost Belt area the Northeast-Midwest that depends on a lot of home heating fuels, and thus there could be some kind of offsetting mechanism so that there you could maintain an equity across the board, but yet achieve it.

Thank you.

Mr. CHIMERINE. I happen to agree with you very strongly and in fact I always liked the contingency tax idea. I don't know why that has disappeared.

The CHAIRMAN. We did have it. It was proposed by the administration.

Mr. CHIMERINE. That is right.

The CHAIRMAN. Should have been kicked in——

Mr. CHIMERINE. There are two good arguments for it. First of all, it is reasonable to expect that sometime in the 1990's, the growth in Federal spending will slow dramatically. Once the buildup in military spending peaks, you are not going to have as much upward pressure on spending. Second, if you make changes in the entitlement programs, savings tend to accumulate later on and the savings get larger, but in the short run you don't have that much effect on deficits.

If you had a contingency tax where you are adding to the tax burden tied to future deficits, there are two things you can expect. No. 1, as spending growth slows for these reasons, that might allow you to remove the tax increase and second, you are providing a strong inducement for Congress to make new spending cuts in the future because they can take credit for the elimination of that tax increase or temporary tax increase. I like that idea. I don't know why it disappeared over the last year or so.

The CHAIRMAN. The administration once proposed that idea then they have since backed off of it. I tend to agree. I think the great incentive for the Congress in particular decisions, painful decisions, is when they know for sure that you are going to go downward to a balance. The problem that I see with Gramm-Rudman is that all you are doing is changing the procedure. You have no assurance that in 1991 you are going to reach a balance. It is a political quick-fix, and I understand its attractiveness but I suspect that it is probably going to run through here like a freight train and people are going to go and campaign and say I voted for a balanced budget. We are going to have one in 1991. As you gentlemen pointed out, all you have done is put into place another procedure, another budget act, another modification of the Budget Act, with deadlines and dates, but does not insure reaching them, whereas if you did something like what we have talked about, there would be a clear incentive for restraining spending because you would be able to go home each year and say we have reduced the deficit by *x*, *x*, *x*, *x*, and you would be able to see it very clearly.

Well, with that little speech on my part, Dr. Allen Sinai, chief economist and managing director, Shearson Lehman. It is good to have you here with us, Dr. Sinai.

STATEMENT OF ALLEN SINAI, CHIEF ECONOMIST AND MANAGING DIRECTOR, SHEARSON LEHMAN BROS., INC.

Mr. SINAI. Thank you very much, Mr. Chairman.

Large and continuing excessive Federal budget deficits once again are at the bottom of some severe difficulties in the economy and financial markets. Short run, Congress has been at an impasse over raising the debt ceiling to $2 trillion. Just a few years ago, in October 1981, outstanding U.S. Government debt was at $1 trillion. Continuing huge Federal budget deficits have required a heavy volume of Treasury financing, raising the debt and debt service burdens for the Federal Government at an ever-increasing pace.

At the same time, especially in recent years, the string of high deficits has induced a tighter monetary policy than otherwise would have been necessary, contributed to record high nominal and real interest rates, a too high dollar, increasing trade deficits, intensive foreign competition over tradable goods, and a fallout on the performance of the industrial sector, financial institutions, and even the rest of the world that threatens the current expansion.

Indeed, the current parameters of performance for the U.S. economy are becoming increasingly disturbing. For the past year, the

U.S. economy has been in a growth recession, there has been a squeeze on corporate profits, growth in real income has slowed down substantially, the unemployment rate has hardly budged, trade deficits have risen to new heights, much of the goods-producing sectors of the economy are in recession, and large shares of our industrial base now have been taken up by other countries.

How have the budget deficits contributed to this poor economic performance?

The slowdown of the past year is a direct result of imbalances in the fiscal-monetary policy mix since 1981, which was set into motion principally by massive tax reductions. The resulting long string of huge U.S. Federal budget deficits, record trade deficits, recession in most goods-producing sectors of the U.S. economy, and increasing debt are intertwined. Large Federal budget deficits, in the context of a monetary growth or nominal GNP growth targeting policy for the Federal Reserve, stimulate economic growth and raise nominal and real interest rates.

In an open economy with flexible exchange rates, higher interest rates strengthen the domestic currency. A stronger dollar holds down inflation and raises real interest rates which, in turn, further strengthens the dollar.

Because of strong economic growth and a strong dollar, imports increase and exports decrease, resulting in a worsening trade deficit. So long as huge Federal budget deficits remain and other countries do not stimulate their economies, the process is bound to continue until foreign trade becomes so weak that economic growth slows.

Under a growth targeting policy by the central bank, short-term interest rates drop and the dollar declines. However, with no intervention to tighten the budget, there is no guarantee that interest rates and the dollar will drop enough to sustain growth. The eventual result is a lopsided, unbalanced economy, with numerous problems—including chronic Federal budget deficits, an overvalued domestic currency, permanent erosion in the relative market shares of the basic industrial sector and industries, stagnant economic growth, high unemployment, still too high inflation, high real interest rates, and a fallout of failures in beleaguered sectors, industries, and financial institutions.

Profits are squeezed and incomes grow slowly. Higher inflation is expected and expected real returns on dollar-denominated assets fall. The dollar can weaken further and inflation increase. Stagflation, although not so bad as in the 1970's, is the eventual likely possibility. Such a trend already seems in evidence.

The way out of the current malaise is to redress the unbalanced policy mix that exists. Indeed, a dose of budget tightening and an easing of monetary policy did take place this year, the third correction to the policy mix problem in the last 4 years.

In 1982, the Tax Equity and Fiscal Responsibility Act was implemented and monetary policy eased. During 1984, the Deficit Reduction Act was passed and during the second half the central bank eased. In each of these instances, the twist in the policy mix away from a loose fiscal tight money combination toward a tighter fiscal easier money mix was carried out in response to a near crisis.

In 1982, the problem was that the economy remained in recession. In 1984, the difficulty was a surprising rise in interest rates and weak growth in the second half. This year, the crisis was in the too high dollar and accelerated decline of the tradable goods sector in the U.S. economy. Crisis management, in a case-by-case reaction, has been the manner by which policy has dealt with the problems that stem from the deficits.

But despite a sizable dent in the prospective budget deficits in this year's budget tightening, not enough was done. Shearson Lehman Economics estimates that the budget savings of the first concurrent resolution were overstated and deficits underestimated. Instead of $55.5 billion of savings in fiscal year 1986, only $21 billion of bona fide savings actually will occur. Rather than the $276.2 billion of savings in fiscal years 1986 to 1988 indicated in the budget resolution, only $132.6 billion of bona fide savings are in place.

Taking a realistic account of the legitimate savings in the budget resolution and using more realistic economic assumptions than the administration and Congress, results in projections of deficits that range from $202.3 billion in fiscal year 1986 to $173.6 billion in fiscal year 1988. The estimates printed in the budget resolution are $171.9 billion in fiscal year 1986 and $112.9 billion in fiscal year 1988.

Additional deficit reduction thus is necessary to establish conditions that can lead to a fundamental resolution of those factors responsible for the poor performance of the U.S. economy.

The move toward protectionism in the United States is another consequence of the failure to correctly align fiscal and monetary policies. So long as real interest rates and the dollar remain high, the U.S. industrial sector will keep losing market share, with all of its attendant failure fallout. Rising protectionist sentiment is a natural outgrowth of the squeeze on the U.S. industrial sector. Rather than defusing protectionism by a stop-gap policy of market intervention, such as is embodied in the G–5 agreement, it would be far better to tighten the budget and ease monetary policy.

The G–5 agreement, recent trade policy initiatives by the administration, and shift in approach to the LDC debt problem are additional examples of crisis management reactions, employed because of a failure to deal with the fundamental problem of the unbalanced policy mix.

In the absence of fundamental improvements on the budget deficit and an offsetting relaxation of monetary policy, the U.S. economy will continue to be characterized by periodic crises and defensive reactions by the policymakers—with increasing risks of recession.

THE ECONOMY'S STATUS

The economy currently is exhibiting a chronically slow growth pattern, with numerous problems stemming from the effects of policy imbalances. Uneven performance over time, across sectors and industries, between regions, and in the world economies have been a consequence. Recession in 1981–82, a boom in 1983–84, and a growth recession in 1985 and perhaps 1986 have occurred. Services sectors activities are strong; goods industries are weak. The Northeast, Southeast, and some mid-Atlantic States, heavily dependent on services, show a strong economic performance. The Midwest, Southwest, South Central, and North Central areas of the country are showing considerable weakness. Growth in the U.S. economy has slowed, also in the Far East. The LDC economies are weak. The Western European economies seem to be improving, but still are plagued by high unemployment.

The recent performance of the U.S. economy clearly indicates that the negatives of the imbalances in fiscal and monetary policy are finally coming home to roost.

After a superlative performance for 1983 and much of 1984, the performance of the U.S. economy has been deteriorating over the past year. From the fourth quarter of 1982 to mid-1984, the economy grew at a 7.1 percent pace. Since mid-1984, real economic growth has been only 2 percent, well below potential growth of 3 percent. During the first half of 1985, real economic growth was only 1.1 percent. Any rebound in the third quarter, for which a boost of auto sales was responsible may have borrowed, from the future, and is likely to be followed by further sluggish growth.

Between November 1982 and November 1984, the unemployment rate dropped from 10.7 percent to 7.1 percent. Since November 1984, the unemployment rate has hardly budged, remaining at 7.1 percent.

Between November 1982 and August 1984, industrial production rose by 22.8 percent. In the past year, industrial production has risen only 1.1 percent.

Between the fourth quarter of 1982 and the third quarter of 1984, business fixed investment rose $48 billion or 29.7 percent. Since last summer, business spending in plant and equipment has risen by $10.8 billion or 5.1 percent.

Since the fourth quarter of 1982, real net exports have declined $57.5 billion. For the five other expansions that have lasted this long, the average change in net exports was a positive $2.3 billion.

Between November 1982 and currently, manufacturing employment has increased by 1.2 million persons; mining employment is down 70,000 persons; and agricultural employment has dropped 507,000 persons. Since January, total employment in the goods sectors of the U.S. economy is down 163,000 and manufacturing employment has dropped by 338,000 persons. Services employment, on the other hand, has grown robustly, rising by 7.5 million persons since the expansion began and a large 1.9 million persons since January. A split personality has developed for the U.S. economy, with essentially a recession in goods-producing industries and a near boom in services.

After an extraordinary rise of 55.9 percent from July 1980 to March 1985, the dollar is now declining sharply, raising the potential for higher inflation in coming months. Since its high in February, the dollar has dropped 15.5 percent against the trade-weighted average of foreign currencies. Since the G-5 Agreement, the dollar is down about 5.5 percent.

From the fourth quarter of 1982 to mid-1984, aftertax corporate profits rose a large 49.4 percent. Since last year, aftertax corporate profits are down by 8.3 percent.

Between the fourth quarter of 1982 and mid-1984, real disposable income rose 9.2 percent. Since last summer, real disposable income is up by only 3.4 percent.

Numerous business and financial institutions are in a fragile condition, with high interest rates for so long, the too high dollar, disinflation, and intense foreign competition contributing to a large number of failures in agriculture, business institutions, and for financial institutions.

Finally, over the past year, the U.S. economy has exhibited a growth recession, growing at less than potential output in three of the past four quarters.

[Charts and tables referred to in testimony may be found in Mr. Sinai's prepared statement.]

Mr. SINAI. The economy also is now showing a growing adverse split of nominal GNP between growth and inflation. Earlier, real growth was exceptionally strong and inflation rates were low. Now, a greater proportion of nominal GNP is in inflation and a smaller one for growth. [See Chart 1.]

THE BUDGET OUTLOOK

Unfortunately, not enough was done in this year's budget tightening to fully resolve the deficit dilemma. Although almost as big a dose of restriction occurred as in the TEFRA tax hike in 1982, the bona fide budget savings are far less than indicated and the projections of deficits are understated [table 2].

The savings claimed in the congressional budget resolution was $55.5 billion in fiscal year 1986, $90 billion in fiscal year 1987 and $130.7 in fiscal year 1988—$276.2 billion over 3 years. The savings claimed in the budget resolution consists of $27.5 billion in defense outlays and $25.3 billion in nondefense spending for fiscal year 1986, cumulating to $137.3 billion in defense savings and $108.6 billion in nondefense savings over the next 3 years. Lower debt service costs saved $2.7 billion in fiscal year 1986 and $30.3 billion between 1986 and 1988. Of the alleged savings 49.7 percent are in defense, 39.3 percent in nondefense, and 11 percent in reduced interest costs.

These savings are overstated, however. Shearson Lehman estimates show that bona fide budget savings of only $21 billion can be expected for fiscal year 1986. For all 3 years covered, the budget savings are $132.6 billion rather than the $276.2 billion indicated by the congressional budget resolution. The difference is due to questionable savings in nondefense as well as overestimates of the baseline starting point, and, by extension, the savings for defense. Table 3 shows the Shearson Lehman estimates of the real savings in the current budget resolution.

The Federal budget deficits are projected by the budget resolution to steadily decline from $209.8 billion in 1985 to $171.9 billion in 1986, and eventually to $112.9 billion in 1988 [table 4]. If these figures are correct, there would be a dramatic shift in the fiscal posture of the Federal Government. A deficit of $209.8 billion for 1985 represents 5.5 percent of nominal GNP. A $12 billion deficit, under the assumptions used by the budget conferees, would equal 2.3 percent of GNP. The decline in the deficit: GNP ratio would be almost as large and would occur as quickly as the escalation of that ratio between 1980 and 1983, when the deficit rose from 2.9 percent to 6.4 percent of GNP.

Unfortunately, the deficits projected in the budget resolution are too low. Questionable savings in nondefense add $9.9 billion, $12.2 billion, and $21.5 billion to the deficits in fiscal year 1986 and to fiscal year 1988.

In addition, the relatively optimistic economic assumptions on growth—4 percent per year; the unemployment rate—steady declines to 6.4 percent; and interest rates—5.9 percent on the 3-month Treasury bill rate by fiscal year 1988 and 7.8 percent for the long-term Treasury bond, used by the budget conferees are a major source of the underestimated deficits.

Economic reestimates, based on economic forecasts, shown in table 5, of slower growth—2.4 percent real growth in 1985, 2.9 percent for 1986 and above potential growth in fiscal years 1987 and 1988; generally higher interest rates especially in 1987 and 1988—7.4 percent to 7.8 percent on the 91-day Treasury bill rate and between 10 percent and 11 percent on the long-term Government bond, higher unemployment rates—gradually declining to just under 7 percent; and somewhat higher inflation rates—rising to an average of 5 percent in 1987–88 after remaining below 4 percent in 1985–86, add $20.5 billion to the estimated deficit in fiscal year 1986, $25.67 billion in fiscal year 1987, and $39.2 billion in fiscal year 1988. The high deficits also add more interest expense, given the greater amount of outstanding debt that would result.

A more realistic estimate of the fiscal year 1988 deficit, based on a more pessimistic outlook than that of the administration but assuming no full-blown recession and the elimination of questionable savings, is near $174 billion, or 3.6 percent of GNP [table 6].

The budget compromise is a case of a half empty-half full cup of wine, an example of crisis management which has not been sufficient to fully resolve a problem. The concurrent budget resolution was better than none at all, but insufficient to fully resolve the problem of the deficits. A significant tightening of the budget was accomplished, with $21 billion of bona fide spending cuts in fiscal year 1986, $44.3 billion in fiscal year 1987, and $67.3 billion in fiscal year 1988, but not enough to permit a full rebalancing of the unbalanced policy mix that is at the heart of the current difficulties of the U.S. economy. The budget deficits are now on a declining path, and Federal Government spending, in real terms, will grow far more slowly in future years—about 2 percentage points or so less than if there had been no compromise. But the structural deficits still remain to keep interest rates higher, the dollar stronger, the trade deficit weaker, and trade debt increasing by more than otherwise.

THE ECONOMIC OUTLOOK

Recent data present a mixed set of signals on the economy. The data for July were almost uniformly bad, but the data showed that August was a strong month. Consumer spending, durable goods orders and employment, especially in services, were considerably stronger. But, at the same time, the industrial sector of the economy continued to show only small signs of ending its long period of deterioration.

In the third quarter the real economy rebounded more than was suggested in the "flash" estimate of the Department of Commerce. Data since the report show a better trade balance than was assumed. Strong auto sales indicated more consumption than probably had been estimated. But inventories probably were lower. The net result should be a growth rate of about 3½ percent.

At issue is the staying power of this rebound. First, the bulk of the increase occurred in consumpton spending and the Federal Government purchases. The Commerce report on consumption for August indicated a surge in durable goods spending from much higher auto sales. Since the burst of auto sales likely resulted from temporary cutrate financing, consumption spending rose much faster than income and the savings rate dropped to a 25-year low, it is likely that consumer spending will fade significantly in the fourth and first quarters. The increase of Government purchases was buoyed by a big increase for Commodity Credit Corporation payments to farmers that also might be transitory.

Second, little change was estimated for business fixed investment by the Department of Commerce, and, if true, a distinct negative for the economy. If consumption spending should fade in the fourth quarter and beyond, then it is hard to see how business fixed investment can improve much.

Finally, inventory accumulation was down in the third quarter compared with the second, undoubtedly the result of a destocking of auto inventories. Since 1986, auto sales have been borrowed against in exchange for third quarter sales, automakers may well be caught with excess inventories in relation to sales in the new model year, having to cut back later.

As table 7 shows, consumers are heavily in debt, with outstanding debt relative to income at postwar highs, and delinquency rates on mortgage and installment credit having moved sharply higher. With the consumer saving rate below 3 percent, some retrenchment is inevitable.

What is keeping household spending and borrowing up appears to be still reasonable monthly loan repayments, both for mortgages and auto loans, relative to income, compared with historical experience. But, with these financial statistics, consumer spending almost certainly will fade.

For the fourth quarter, growth is likely to weaken to about a 2½-percent pace, reflecting the slowdown in consumer spending and less improvement for net exports, if any, compared with the third quarter. Stronger growth may well be generated by a rebound of inventories, but this would be a sign of weakness rather than strength, especially if inventories were built up in the automotive sector.

For the future, the current economic outlook at best, suggests better growth in the U.S. economy over the next four quarters than the last, but with increasing risks of recession from the fallout of past imbalances in fiscal and monetary policies. Growth for real GNP is projected at 2 percent in 1985, fourth quarter to fourth quarter, and 2.9 percent in 1986, far less than the administration and Federal Reserve expectations. This pace of growth offers little hope for an end to the chronic problems that are besetting the United States and world economies.

Inflation rates, while low, around 3 percent or so, will come under upward pressure in 1986 and beyond. The unemployment rate may yet rise from the current 7.1 percent and, in any case, is not likely to decline much. Pressure on corporate profits is likely to continue. And, the split performance of goods versus services activities seems set to continue.

More stopgap solutions to the problems stemming from large Federal budget deficits, slow economic growth and sectoral imbalances—such as the recent G–5 Agreement—seem likely. But, although some signs of improvement should appear, the problems will not be resolved. Without a further correction of the unbalanced mix of fiscal and monetary policies, third and fourth best solutions can only delay what could be a losing battle in sustaining the economic expansion.

The Shearson Lehman Brothers economic forecast presents a "muddling-through" scenario for the next couple of years. The expansion should continue, getting a second wind from lower inflation, lower interest rates, and lower dollar. If all else fails, the central bank will step in to keep the economy expanding. The harmful effects of recession in the United States and world economies far outweigh the risk of reinflation. Sustained growth is likely, but probably subpar in 1985 and 1986, with a one-in-four risk of recession. The reduced inflation, lower interest rates, lower dollar, and accommodative Federal Reserve policy envisioned do not insure growth in the 3- to 4-percent range and a gradual decline of the unemployment rate, however.

More of a fundamental correction in the policy mix is required. A shift in the profile of spending, still low inflation, better corporate profits, slower monetary growth, somewhat lower interest rates, and declining budget deficits characterize the projections.

For the rest of this year, growth is expected to be relatively weak, declining from the third quarter because of reduced auto sales and weaker household spending. For next year, an improvement in net exports is expected to contribute most to improved growth, with only modest increases for consumption spending and business fixed investment. Housing and residential construction should be firm, but not rise much. Business is expected to keep inventories lean in relation to sales. And, Federal Government spending is forecast to ease off to a 3.1-percent annual rate, compared with the 8.7 percent of 1985.

Inflation rates fluctuate between 3 and 3½ percent, tilting upward as 1986 progresses from the lagged effects of a lower dollar. The dollar drops another 10 percent or so from current levels over the next year, reflecting negative fundamentals and periodic intervention by the G–5 countries. Profits should do better in 1986 than 1985, rising by about 7 percent because of cost cutting, earnings translation under a weaker dollar, and improved sales. Monetary growth is forecast to move to within target ranges for the next year and interest rates are stable to somewhat lower. Stock prices enjoy a modest rise as a result.

How can the expansion continue? The economic slowdown has not been all bad; indeed, it has probably enhanced the potential for sustained, albeit subpar, growth. Byproducts include lower inflation, lower interest rates, and a lower dollar.

Lower inflation enhances household and business purchasing power; lower interest rates increase the affordability of household durable goods and reduce the costs of financing; the lower dollar should, with lags, act to reduce imports and enhance exports. All of these are necessary in order for the expansion to be sustained.

Essentially, lower interest rates and a lower dollar should help stimulate the tradable goods sector which, in turn, benefit U.S. producers. Lower inflation will sustain the real purchasing power of households and business and spending should continue to rise, although only modestly. When necessary, the central bank is expected to step in with a slight easing. But increasingly as the expansion wears on, the central bank will find itself unable to provide strong doses of ease.

The relatively sanguine forecast of sustained growth depends on a number of critical assumptions, however, most having to do with economic policy.

First, it is assumed that the budget tightening of the past summer results in slowed economic and monetary growth, thus permitting more leeway for the Federal Reserve to be accommodative or to ease somewhat to sustain growth.

Second, the Federal Reserve is assumed to ease later this year, helping to reduce real interest rates and the dollar another notch. This assumption is open to question, however, given the rapid decline in the dollar already and the growing potential for a dollar-induced reinflation. The central bank fears this eventuality.

Third, no major protectionist legislation is assumed, a somewhat risky view unless the U.S. industrial sector improves greatly over the next year.

Fourth, tax reform is assumed to be neutral in its impacts on macroeconomic growth. The risk is that as it currently stands, the tax increases for business could bring a major slowdown in the first year of passage.

Fifth, the G-5 intervention is assumed to accelerate the decline of the dollar, since the dollar would have dropped anyway, helping to speed a turnaround in foreign trade.

However, the risk here is that without underlying fundamental reforms in the monetary and fiscal policies of the United States and the rest of the world, no lasting benefit or improvement can occur for the U.S. industrial sector.

Sixth, it is assumed that weakness in the goods sectors is not carried over into the services sectors, so services activities can keep carrying the economy.

Seventh, oil prices are expected to decline further, offsetting the potential reinflationary effects from a weaker dollar.

How would a recession arise?

One way is through fizzling out, a fading into a downturn as demands weaken and the competitive pressures on the tradable goods sectors take their toll. The other eventuality leading to a recession would be a dollar collapse, stronger growth than expected because of improving net exports, excessive monetary growth, accelerated inflation, higher interest rates, and restriction by the Federal Reserve.

With the economy about to enter the fourth year of a current expansion, the possibility of a recession is well within the realm of the historical averages. For the postwar period, the average length for expansions has been 44.3 months. Excluding war years, the average length is near 34 months.

So far, the classic characteristics that precede a recession are not present. These include, but are not limited to, output nearing capacity, bottlenecks and shortages, upward pressure on prices and wages, heavy credit demands, rising interest rates, a tightening of Federal Reserve policy, rising inventory: sales ratios, and then often a credit crunch.

Currently, the only excess that has been present has been a mild accumulation of unwanted inventories, which has been in the process of correction now for some months.

The traditional pattern could arise in the current environment, however, through the mechanism of the dollar, international trade, and international finance. The decline in the dollar might turn into a freefall, if foreign holders of dollar-denominated assets begin to turn away from the currency.

This can happen because of expectations that the dollar is headed lower, out of disenchantment with the prospects for the U.S. economy, from improved prospects in other countries, or a resurgence of inflation from the dollar decline itself.

The declines in the dollar, with lags, should produce increased real economic growth through a turnaround in foreign trade and also higher inflation. The extent of any reaction on inflation from a lower dollar is uncertain, but it is now becoming better known that the disinflation of the past 5 years was very much an effect of a strong dollar. Sharply higher inflation could result from a declining dollar.

Increased real economic growth and higher inflation could bring a surge in monetary growth, forcing the central bank to tighten monetary policy. In this situation, many of the traditional prerecession features would arise. A recession would likely occur in late 1986 or early 1987, worsening the deficits further.

Table 9 shows the sensitivity of Federal budget deficits to changes in real economic growth, inflation, the unemployment rate, and interest rates, as estimated by Shearson Lehman Economics.

Weaker real economic growth can be seen to have the biggest impact on raising budget deficits. Real economic growth of 2 to 3 percentage points less over the next 3 years would raise the budget deficits by anywhere from about $10 billion in fiscal year 1986 to $75 billion in fiscal year 1988. The higher inflation would reduce the budget deficits, however, offsetting some 50 to 60 percent of the worsening.

Higher interest rates, perhaps 2 to 4 percentage points under a tighter monetary policy, would raise the deficits significantly. All in all, under the traditional path to a recession by late 1986 or 1987, the fiscal year 1988 budget deficit might reach $250 to $270 billion.

Shearson Lehman assigns a probability of 10 percent to this prospect.

The second way to a recession would be through a fizzling out of the current expansion. While normally not the manner by which a recession occurs, the current business cycle experience is quite different from previous ones. An autonomous increase in savings by households, already overextended in borrowing and spending relative to income, could drive the economy lower quite soon. The weakness in the industrial sector, which seemed to intensify in September, is another factor suggesting a possible near-term recession.

In this situation, the economy could decline soon, late this year or during the first half of 1986, with real economic growth dropping sharply. However, in this situation, inflation rates likely would drop further, interest rates would decline, and unemployment rise, creating higher budget deficits but not so much as would be the case in the traditional approach to a recession. Lower real economic growth might cost some $8 to $35 billion in additional deficits over the next 2 fiscal years.

Lower inflation would add another $4 to $15 billion to the deficits. But sharply lower interest rates could subtract $6 to $18 billion from the deficits over the same time period. A higher unemployment rate might add $5 to $10 billion to the deficits. The result would be deficits on the order of $210 billion to $215 billion in fiscal year 1986 and $230 billion in fiscal year 1987, compared with the $202.3 billion and $192.5 billion in the basic Shearson Lehman forecast. The deficit would be higher than the $172.6 billion projected for fiscal year 1988, but improving compared with fiscal year 1987.

The odds on this possibility are assessed at 15 percent. Thus, the risks of recession total 25 percent, and with it the possibility that much higher deficits, a larger volume of Treasury financing, and debt interest charges could escalate even more than the baseline scenario.

Charts 2 and 3 show the pattern of debt relative to GNP and of interest charges relative to GNP under a worst case and more optimistic scenario for economic growth, inflation, and interest rates.

The dotted lines show the results of more pessimistic projections about real economic growth over the next 40 years, along with the interest rate forecast of Shearson Lehman Economics. The solid lines show the results if growth is more rapid than recently and interest rates on short- and long-term Government debt average around 7 or 8 percent. The dotted line is the result of any sequence of events that might produce periodic recessions, set into motion over the near term.

Probably the truth lies somewhere in between, but the possibility of explosive growth in outstanding Federal Government debt relative to GNP or in debt service as a percentage of GNP is distressingly high; perhaps the most compelling reason for cutting deficits.

BUDGET DEFICITS, POLICY, MIX, AND ECONOMIC IMPACTS

As an approximation to the potential effects of further reductions in the budget deficits, such as might be embodied in the

Gramm-Rudman amendment to the debt ceiling bill, the Shearson Lehman model of the U.S. economy was used to simulate the impacts over the next few years of reductions in the deficit, achieved through changes in spending. Table 10 summarizes the results.

The reductions in Federal Government spending necessary to close the deficit gap, after feedback, range from $33 billion in 1986 to $105 billion in 1988. The result is weaker real economic growth, with a bigger impact in the first year of the fiscal restraint. The mix of final economic activity shifts, with weaker consumption spending and less accumulation of inventories, but somewhat stronger business fixed investment and much more activity in net exports, interest rate and dollar sensitive sectors. Housing activity also is indicated to be higher.

The reduced Government spending lowers interest rates, both short and long term, anywhere from 60 basis points to 169 basis points over the next 3 years for long-term corporate bonds and in a range of 17 basis points to 182 basis points for short-term interest rates.

If the economy were already growing very slowly, the fiscal restraint might well tip the economy into recession. The weaker monetary growth associated with the slower pace of growth in the economy would permit considerably more leeway for the Federal Reserve to ease, if desirable.

ECONOMIC POLICY AND SUSTAINING THE EXPANSION

To sustain the expansion at a pace that is adequate for reducing unemployment requires further declines in interest rates and the dollar.

Crisis management action such as the G–5 intervention can accelerate declines in the dollar and speed an improvement in foreign trade. But without changes in the underlying policies of the countries concerned, a lasting improvement is difficult to achieve. Fundamentally, if the U.S. budget deficits are still too large and monetary policy tighter than necessary, real interest rates and the dollar will be too high to sustain the expansion at the 3- to 4-percent rate that would bring the unemployment rate down to a full employment zone.

A sustained and orderly decline in the dollar—if it could be engineered—would improve net exports, increase economic growth, stop the declines of commodity prices, and push up corporate profits. Protectionist legislation that could interfere with world trade and financial flows also might be defused. Dollar declines, however, while good for economic growth and profits, do risk reinflation. Any decline must be gradual, which is difficult since markets usually do not move in that manner.

There are several policy options available. First, and ideally, would be further reductions in the Federal budget deficits. Such a tightening should be offset by a compensating ease in monetary policy. By a compensating ease is meant injections of bank reserves to raise monetary growth to the levels that would have existed before the budget tightening. The effects of such a policy twist would be lower nominal and real interest rates, a drop in the dollar, and higher equity prices.

Little change in overall growth should be expected. But there would be a decided shift in the composition of economic activity, with increased growth in the goods sectors and less activity in the services sectors. Although slow in coming, U.S. industries probably would begin to regain some of its lost market shares.

At this point, much less is required to close the remaining deficit gap. With the string having run out on reductions in spending as a means to reduce the deficits, higher taxes or increased growth provide the main alternatives for further deficit gap closing.

Full employment budget calculations provide estimates of the reductions yet necessary, estimated to be $117.4 billion in fiscal year 1988. Another possibility is a sufficient amount of deficit reductions to lower the unified budget deficit to approximately $100 billion in fiscal year 1988, or 2 percent of nominal GNP, the target originally set by the Congress and administration. In the latter case, according to the current budget deficit estimates of Shearson Lehman Economics, about $75 billion of deficit reduction by 1988 would be necessary.

How much of the deficits can be eliminated through increased economic growth?

The Federal budget deficits are most sensitive to interest rates, growth, inflation, and the unemployment rate. An easier monetary policy that reduced interest rates by 1 percentage point could reduce the budget deficit by $14 billion in fiscal year 1988. If, at the same time, 1 percentage point of additional real economic growth was induced, another $37 billion of deficit reduction would occur.

If inflation rates were one-half percentage point higher and the unemployment rate 0.3 percentage point lower, then by fiscal year 1988 another $5.5 billion reduction in the deficit would be achieved. The total of $56.5 billion by fiscal year 1988 would reduce the estimated deficit to $117.1 billion, just $17.1 billion above the $100 billion or 2 percent of nominal GNP target. Only a very modest tax hike would then be required to eliminate the $15 to $20 billion difference, perhaps accomplished by oil import surcharges or a tax proposal that did not lower marginal tax rates as much as in the administration's tax proposals.

To completely remove the full employment budget deficit by fiscal year 1988 would require a considerably larger tax increase. For example, an oil import surcharge of $5 per barrel would raise $10 to $15 billion of revenues. To remove the remainder of the full employment budget deficit would require something like the enactment of tax reform, with higher individual and corporate tax rates than envisioned by the President.

A second possibility is for the Federal Reserve to ease in order to defuse the current situation. Such action may be inevitable, but ultimately cannot work unless the budget deficit also is reduced. Loose fiscal and loose monetary policy can only produce higher inflation and higher interest rates in the long run. Without further deficit reductions, the central bank would only ease slightly.

A third possibility is continuing intervention to drive the dollar down enough to eliminate the current account deficit. More currency reserves than are available would be necessary here. And, a lower dollar would set up pressure for higher interest rates, and thus is self-limiting.

Clearly, most choices cannot necessarily produce a sustained expansion. Only a further redressing of the unbalanced policy mix offers assurance of sustaining the expansion, with a tighter budget providing the central bank with much more room to ease.

The Gramm-Rudman amendment passed by the Senate offers one possible way to close the remaining deficit gap, setting up a pattern of spending reductions of $36 billion per year to the fiscal year 1986 budget deficit estimated as an average of OMB and CBO forecasts.

The amendment is set up to require across-the-board reductions in nondefense and defense spending that are not exempted if deficits exceed the ceilings set each year. Neither the Congress nor the President has a great deal of leeway in any arbitrary choice of spending reductions, although some new power does shift to the Executive. Social Security payments and interest payments are, of course, exempt. About 50 percent of the budget would be available for cuts under this program.

Certainly, a phased out series of reductions in the budget deficits through additional spending cuts would be a positive approach to eliminating Federal budget deficits, reducing interest rates, helping to revive activity in interest and dollar-sensitive sectors, and produce weaker growth in the economy that could be offset by Federal Reserve easing. Tax increases might also be possible, but more contentious if opposed by the President.

There are other problems. One is that a too-heavy cutting of the budget might be required if deficits were very large relative to the ceilings. The Congress and administration might be in a position of having to tighten fiscal policy sharply and perhaps propel the economy into a recession.

No. 2. The funds available to be cut may be inadequate given the task of budget tightening that is required. Programs, both nondefense and defense, might be slashed down, when, in fact, they were desirable.

No. 3. Some threat to national security is possible, depending on international events, because of defense spending reductions.

No. 4. The automatic nature of the amendment precludes deliberation as to which programs should be cut. If exceptions and overrides were begun on some matters, then the plan might not produce the desired result.

Once again, this amendment is an example of crisis management which begs the basic issue of correcting budget deficits originally caused by massive tax reductions.

With adjustments to remove some of the weaknesses, the Gramm-Rudman approach may well serve as an appropriate mechanism to stage in budget deficit reductions, the necessary budget-cutting to correct the existing imbalance in fiscal policy. If such a program were enacted, it will be equally important for the central bank to provide a significantly easier monetary policy, as well.

SUMMARY

Budget policies have had and are having a major impact on the performance of the United States and world economies. Massive tax cuts were responsible for the superlative performance of the

U.S. economy in 1983 and 1984 and the revival in growth of the rest of the world economies, as well. But the very policies that created that strength also led to an unprecedented string of budget deficits which are now responsible for most of the negatives that characterize the economy.

The current negatives—which include stagnant economic growth in the United States, weakness in profits and incomes, still high real interest rates, a still strong dollar, intense foreign competition, continuing loss of market shares to the rest of the world on tradable goods, essentially a recession in goods-producing industries, especially manufacturing, the inflationary threat of a declining dollar, the rising threat of protectionism, and monetary policy that is hamstrung because of a declining dollar and excessive monetary growth—stem from the loose fiscal-tight monetary policies of previous years. Unless reversed, a policy mix in an open economy with flexible exchange rates must ultimately produce stagflation and a slow demise of the industrial base.

Sooner or later, policymakers will realize that the only solution for these difficulties lies in rebalancing an unbalanced mix of monetary and fiscal policies in the United States and abroad. Twisting the U.S. policy mix to a tighter budget and easier monetary policy and reversing this twist abroad is necessary.

A coordinated attempt to do so is preferable to a coordinated attempt to drive the dollar down through currency intervention. The problems of an unbalanced policy mix have been severe enough so that three times in the last 4 years a twist in the policy mix has been necessary: In 1982, 1984, and 1985. Rather than management by crisis, it is time to move toward a more permanent solution to these problems.

Recommendations: One, the administration should declare its intention to eliminate the structural budget deficits by 1990, raising taxes within the framework of the new tax reform proposals and urging that other countries stimulate their economies. The shift in the policy mix of the United States and its trading partners should be accomplished gradually, but in a planned and coordinated manner over the next 5 years and staged to prevent dislocations in financial markets.

Two, at the same time, the Federal Reserve should declare its intention to contribute to deficit reduction by engineering lower interest rates and higher economic growth than recently, providing a compensating ease in monetary policy to offset the fiscal restraint that balances the budget.

Three, through these actions, the path to deficit reduction will eventually end up including the spending reductions accomplished by the Congress in 1985; tax increases; and an increase of economic growth—the combination necessary to reduce unified budget deficits to 2 percent or less of nominal GNP by fiscal year 1988.

Four, the Finance Ministers and the Treasuries of G-5 countries should agree that intervention will be used to maintain orderly movements in currencies as shifts in the policy mix are achieved.

Five, selective legislation designed to "protect" those industries in the United States that suffer "unfair" trading practices from abroad should be designed and implemented. Protectionist legislation involving general tariffs, surcharges, or quotas should be avoided.

Six, the President's tax reform proposals, modified so that revenues are raised as part of a package to eliminate deficits, should be enacted, accomplishing in one fell swoop marginal tax rate reductions, base broadening, and revenue enhancement to help eliminate the excess budget deficits and create a more equitable and efficient tax system.

What would be the impacts of this coordinated policy attack on current problems? Most likely, a new lower profile of interest rates would be established, the dollar weaken, equity prices improve, and the composition of output shift toward a rebalancing of the unbalanced growth in goods and services activities.

The lower interest rates would contribute to an easing of the problems of the LDC countries. The weaker dollar would improve the prospects for countries who must pay debts in dollars. And, sufficient economic growth could be achieved to bring the unemployment rate lower.

One way or another, the policymakers will have to reach a solution similar to what is being suggested, whether piecemeal or well planned. An aggressive, coordinated attack on the growing problems of the United States and world economies is better implemented now, rather than reacting in a crisis management fashion that might fail to sustain expansion.

[The prepared statement of Mr. Sinai follows:]

PREPARED STATEMENT OF ALLEN SINAI*

Introduction

Continuing large federal budget deficits once again are at the bottom of some severe difficulties in the economy and financial markets. Recently, Congress has been at an impasse over raising the debt ceiling to $2 trillion. Just a few years ago, in October 1981, outstanding U.S. Government debt was at $1 trillion. Huge federal budget deficits have required a heavy volume of Treasury financing, raising the debt and debt service burdens for the federal government at an ever-increasing pace (Charts 2, 3, p. 19).

Over the past five years, the string of high deficits has induced a tighter monetary policy than otherwise would have been necessary, contributing to record high nominal and real interest rates, a too high dollar, increasing trade deficits, intense foreign competition, with a fallout on the performance of the industrial sector, financial institutions, and the rest of the world that threatens to end the current business expansion.

Indeed, the current performance of the U.S. economy is disturbing. For the past year, the economy has been in a growth recession, there has been a squeeze on corporate profits, growth in real income has become much weaker, the unemployment rate has hardly budged, trade deficits have risen to new heights, debt and debt service at all levels are a mounting burden, much of the goods-producing activities is in recession, and large shares of our industrial base have been taken up by other countries. No sustained rebound in growth is likely, certainly no where near the expectations of the Federal Reserve, Administration, and CBO.

How have the budget deficits contributed to this poor economic performance?

The slowdown of the past year is a direct result of imbalances in the fiscal-monetary policy mix, which was set into motion in 1981 principally by massive tax reductions. The resulting long string of huge U.S. federal budget deficits, record trade deficits, recession in most goods-producing sectors, and increasing debt are intertwined. Large federal budget deficits, in the context of a monetary growth or nominal GNP growth targeting policy for the Federal Reserve, stimulate economic growth and raise nominal and real interest rates. In an open economy with flexible exchange rates, higher interest rates strengthen the domestic currency. A stronger dollar holds down inflation and raises real interest rates which, in turn, further strengthens the dollar.[1] Because of strong economic growth and a strong dollar, imports increase and exports decrease, resulting in a worsening trade deficit. So long as huge federal budget deficits remain and other countries do not stimulate their economies, the process is bound to continue until foreign trade becomes so weak that economic growth slows. When that happens, as was the case in the second half of 1984, short-term interest rates drop and the dollar declines. However, without intervention to tighten the budget, there is no guarantee that interest rates and the dollar will drop enough to sustain economic growth. The eventual result is a lopsided, unbalanced economy, with numerous problems--including chronic federal budget deficits, an overvalued domestic currency, permanent erosion in the relative market shares of the basic industrial sector and industries, stagnant economic growth, high unemployment, still too high inflation, high real interest rates, and a fallout of failures in beleaguered sectors, industries, and financial institutions. Profits are squeezed and incomes grow slowly. Higher inflation is expected and expected real returns on dollar-denominated assets fall. The dollar can weaken further and inflation increase. Interest rates remain high. Stagflation, although not so bad as in the 1970s, is the eventual likely possibility, with such a trend already in evidence (Chart 1).

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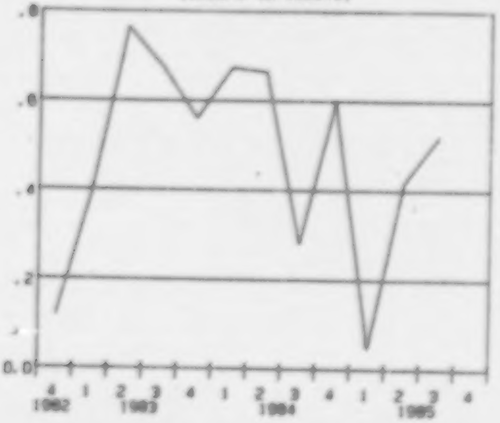
*Chief Economist and Managing Director, Shearson Lehman Brothers, Inc. New York, New York. The budget projections were developed in collaboration with James Capra. Ed Friedman performed the computer simulations with the Shearson Lehman Model.

Chart 1
Output-Inflation Index*
(1982:4 to 1985:3)



*1.0=all growth is in real GNP, 0=all growth is through inflation.

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[1] For estimates of the impact on inflation from a rising dollar, see Allen Sinai, "What Caused Disinflation? The Dollar Did It!" Challenge, September/October 1985, pp. 18-22.

The way out of the current malaise is to redress the unbalanced policy mix that exists. Indeed, a dose of budget tightening and an easing of monetary policy did take place this year, the third correction to the policy mix in the last four years. During 1982, the Tax Equity and Fiscal Responsibility Act (TEFRA) was implemented and monetary policy eased. During 1984, the Deficit Reduction Act (DEFRA) was passed and during the second half the central bank eased. In each of these instances, the twist in the policy mix away from a loose fiscal-tight money combination toward a tighter fiscal-easier money mix was carried out in response to a near crisis. In 1982, the problem was that the economy remained in recession and some LDCs almost defaulted. In 1984, the difficulty was a surprising rise in interest rates during the first half and weak growth in the second half. This year, the crisis was the too high dollar and accelerated decline of the tradable goods sectors of the U.S. economy. Crisis management, through case-by-case reactions, has been the manner by which policy has dealt with the problems that stem from the deficits.

Despite a sizeable dent in the prospective budget deficits through this year's budget tightening, not enough was done. Shearson Lehman Economics estimates that the budget savings of the First Concurrent Resolution were overstated and deficits underestimated. Instead of $55.5 billion of savings in FY1986, only $21 billion of bona fide savings actually will occur. Rather than the $276.2 billion of savings in fiscal years 1986-88 indicated in the budget resolution, only $132.6 billion of bona fide savings are in place. Taking realistic account of the legitimate savings in the budget resolution and using more realistic economic assumptions than the Administration and Congress results in projections of deficits that range from $202.3 billion in FY1986 to $173.6 billion in FY1988. The estimates in the budget resolution are $171.9 billion in FY1986 and $112.0 billion in FY1988. Additional deficit reduction thus is necessary to establish conditions for a fundamental resolution of those factors causing the poor performance of the U.S. economy.

The move toward protectionism in the U.S. is another consequence of the failure to correctly align fiscal and monetary policies. So long as real interest rates and the dollar remain high, the U.S. industrial sector will keep losing market share, with all of its attendant failure fallout. Rising protectionist sentiment is a natural outgrowth of the squeeze on the U.S. industrial sector. Rather than defusing protectionism by a stopgap policy of market intervention, such as is embodied in the G-5 Agreement, it would be far better to tighten the budget and ease monetary policy.

The G-5 Agreement, recent trade policy initiatives by the Administration, and shift in approach to the LDC debt problem are additional examples of crisis management reactions, employed because of a failure to deal with the fundamental problem of the unbalanced policy mix.

In the absence of further reductions in the budget deficits and an offsetting relaxation of monetary policy, the U.S. economy will continue to be characterized by periodic crises and defensive reactions by the policymakers--with increasing risks of recession.

The Economy's Status

The economy currently is exhibiting a chronically slow growth pattern, with numerous problems stemming from the effects of policy imbalances. Uneven performance over time, across sectors and industries, between regions, and in the world economies have been a consequence. Recession in 1981-82, a boom in 1983-84, and a growth recession in 1985 and perhaps 1986 have occurred. Services sectors activities are strong; goods industries are weak. The Northeast, Southeast, and some mid-Atlantic states, heavily dependent on services, show a strong economic performance. The Midwest, Southwest, South Central, and North Central areas of the country are showing considerable weakness. Growth in the U.S. economy has slowed, also in the Far East. The LDC economies are weak. The Western European economies seem to be improving, but still are plagued by high unemployment.

The recent performance of the U.S. economy clearly indicates that the negatives of the imbalances in fiscal and monetary policy are coming home to roost.

- After a superlative performance for 1983 and much of 1984, the performance of the U.S. economy has been deteriorating over the past year. From the fourth quarter of 1982 to mid-1984, the economy grew at a 7.1% pace. Since mid-1984, real economic growth has been only 2%, well below potential growth of 3%. During the first half of 1985, real economic growth was only 1.1%. Any rebound in the third quarter, for which a boost of auto sales was primarily responsible, may have borrowed from the future, and is likely to be followed by further sluggish growth.

- Between November 1982 and November 1984, the unemployment rate dropped from 10.7% to 7.1%. Since November 1984, the unemployment rate has not budged, remaining at 7.1%.

- Between November 1982 and August 1984, industrial production rose by 22.8%. In the past year, industrial production has risen only 1.1%.

- Between the fourth quarter of 1982 and the third quarter of 1984, business fixed investment rose $48 billion or 29.7%. Since last summer, business spending on plant and equipment has risen by $10.8 billion or 5.1%.

- Since the fourth quarter of 1982, real net exports have declined $87.5 billion. For the five other expansions that have lasted this long, the average change in net exports was a positive $2.3 billion.

- Between November 1982 and currently, manufacturing employment has increased by 1.2 million persons; mining employment is down 70,000 persons; and agricultural employment has dropped 507,000 persons. Since January, total employment in the goods sectors of the U.S. economy is down 163,000 and manufacturing employment has dropped by 338,000 persons. Services employment, on the other hand, has grown robustly, rising by 7.5 million persons since the expansion began and a large 1.9 million persons since January. A split personality has developed for the U.S. economy, with essentially a recession in most goods-producing industries and a near boom in services.

- After an extraordinary rise of 55.9% from July 1980 to March 1985, the dollar is now declining sharply, raising the potential for higher inflation in coming months. Since its high in February, the dollar has dropped 15.5% against the Morgan Guaranty trade-weighted average of foreign currencies. Since the G-5 Agreement, the dollar is down about 5-1/2%.

- From 1982:4 to mid-1984, after-tax corporate profits rose a large 49.4%. Since last year, after-tax corporate profits are down by 8.3%.

- Between the fourth quarter of 1982 and mid-1984, real disposable income rose 9.2%. Since last summer, real disposable income is up by only 3.4%.

- Numerous business and financial institutions are in a fragile condition, with high interest rates for so long, the too high dollar, disinflation, and intense foreign competition contributing to a large number of failures in agriculture, business institutions, and financial institutions.

- Finally, over the past year, the U.S. economy has exhibited a growth recession, growing at less than potential output in three of the past four quarters.

Table 1
"Growth Recessions" in the Postwar Period*

Dates	Quarters Into Expansion	Growth	Recession (R) or Continued Expansion (E)	Quarters Until Recession
1951:4 to 1952:2	8	0.8, 3.2, 0.4	R	5
1956:1 to 1956:3	7	-1.6, 2.1, 0.3	R	2
1967:1 to 1967:2	25	0.5, 2.6	E	11
1973:2 to 1973:3	10	0.5, 2.6	R	1
1976:2 to 1976:3	5	2.7, 2.3	E	14
1984:3 to 1985:2	10	1.6, 4.2, 0.3, 1.9 (Average, 2.0)	?	?

*Two or more quarters of less-than-potential growth in GNP.

The economy also is showing a growing adverse split of nominal GNP between growth and inflation. Earlier, real growth was exceptionally strong and inflation rates were low. Now, a greater proportion of nominal GNP is in inflation and a smaller one for growth (Chart 1 above).

The Budget Outlook

Unfortunately, not enough was done in this year's budget tightening to fully resolve the deficit dilemma. Although almost as big a dose of restriction occurred, as in the TEFRA tax hike in 1982, the bona fide budget savings are far less than indicated and the projections of deficits are understated (Tables 2-6).

Table 2
Comparison of Savings From Deficit Resolution
Packages in Recent Years*
(Billions of Dollars, Fiscal Years)

	Year 1	Year 2	Year 3	Total
1982, TEFRA	21.7	43.6	50.6	115.5
1984, DEFRA	10.6	16.5	22.5	49.5
1985, Reconciliation Act (Anticipated)	17.8	22.5	30.5	70.8
1985, Reconciliation Plus Defense	20.7	34.2	51.1	106.0
1985, Bona Fide Savings Except Debt Service	19.4	36.6	49.0	105.0

*Shearson Lehman Economics

The savings claimed in the Congressional Budget Resolution was $55.5 billion in FY1986, $90 billion in FY1987 and $130.7 billion in FY1988 -- $276.2 billion over three years. The savings claimed in the Budget Resolution consists of $27.5 billion in defense outlays and $25.3 billion in nondefense spending for FY1986, cumulating to $137.3 billion in defense savings and $108.6 billion in nondefense savings over the next three years. Lower debt service costs save $2.7 billion in FY1986 and $30.3 billion between 1986 and 1988. 49.7% of the alleged savings are in defense, 39.3% in nondefense, and 11% in reduced interest costs.

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[2] James Capra and Allen Sinai, "Deficit Prospects: Half Empty or Half Full?" Shearson Lehman Brothers Economic Studies Series No. 14, October 1, 1985.

These savings are overstated, however. Shearson Lehman estimates show that bona fide budget savings of only $21 billion can be expected for FY1986[2]. For all three years covered, the budget savings are $132.6 billion rather than the $276.2 billion indicated by the Congressional Budget Resolution. The difference is due to questionable savings in nondefense as well as overestimates of the baseline starting point, and, by extension, the savings for defense. Table 3 shows the Shearson Lehman estimates of the real savings in the current Budget Resolution.

Table 3
Bona Fide Budget Savings*
(Fiscal Years, Billions of Dollars)

	1986	1987	1988	Total
Budget Resolution	55.5	90.9	130.7	276.2
Nondefense	25.3	35.4	47.9	108.6
Defense	27.5	45.2	64.6	137.3
Debt Service	2.7	9.4	18.2	30.3
Questionable Savings	34.5	45.7	67.3	147.5
Nondefense	9.5	10.8	18.6	38.9
Defense	24.6	33.5	45.9	104.0
Debt Service	0.4	1.4	2.8	4.6
Savings	21.0	44.3	67.3	132.6

*Shearson Lehman estimates.

The federal budget deficits are projected by the budget resolution to steadily decline from $209.8 billion in 1985 to $171.9 billion in 1986, and eventually to $112.9 billion in 1988 (Table 4). If these figures are correct, there would be a dramatic shift in the fiscal posture of the federal government. A deficit of $209.8 billion for 1985 represents 5.5% of nominal GNP. A $112 billion deficit, under the assumptions used by the budget conferees, would equal 2.3% of GNP. The decline in the deficit: GNP ratio would be almost as large and would occur as quickly as the escalation of that ratio between 1980 and 1983, when the deficit rose from 2.9% to 6.4% of GNP.

Unfortunately, the deficits projected in the budget resolution are too low. Questionable savings in nondefense add $9.9 billion, $12.2 billion, and $21.5 billion to the deficits in FY1986 to FY1988.

In addition, the relatively optimistic economic assumptions on growth (4% per year), the unemployment rate (steady declines to 6.4%), and interest rates (5.9% on the three-month Treasury bill rate by FY1988 and 7.8% for the long-term Treasury bond) used by the budget conferees are a major source of the underestimated deficits.

Table 4
Congressional Budget Resolution: Deficits and Assumptions*
(Fiscal Years, Billions of Dollars Except
as Otherwise Indicated)

	1985	1986	1987	1988
Revenues	736.5	795.7	869.4	960.2
Outlays	946.3	967.6	1024.1	1073.0
Deficits	209.8	171.9	154.7	112.9
Deficits/GNP (Percent)	5.5	3.8	3.1	2.3
Economic Assumptions				
Real GNP (Percent Change)	4.0	4.0	4.0	4.0
Implicit GNP Deflator (Percent Change)	3.6	4.3	4.2	4.0
Unemployment Rate (Percent, FY Average)	7.0	6.9	6.7	6.4
91-Day Treasury Bills (Percent)	7.6	7.5	7.0	5.9
Long-Term Government Bond (Percent)	11.3	10.5	9.7	7.8

*Estimates contained in the concurrent resolution and the conference agreement.

Table 5
Shearson Lehman Budget Projections and Assumptions
(Fiscal Years, Billions of Dollars Except
as Otherwise Indicated)

	1985	1986	1987	1988
Revenues	737.0	774.0	844.5	941.6
Outlays	943.9	976.3	1037.0	1115.2
Deficits	209.8	202.3	192.5	173.6
Deficits/GNP (Percent)	5.5	4.9	4.3	3.6
Economic Assumptions				
Real GNP (Percent Change)	2.4	2.9	3.5	4.1
Implicit GNP Deflator (Percent Change)	3.7	3.9	4.8	5.3
Unemployment Rate (Percent, FY Average)	7.4	7.2	7.0	6.8
91-Day Treasury Bills (Percent)	7.5	7.4	7.5	7.8
Long-Term Government Bond (Percent)	11.2	10.5	10.8	11.1

Economic reestimates, based on Shearson Lehman economic forecasts, shown in Table 5, of slower growth (2.4% real growth in 1985, 2.9% for 1986 and above potential growth in fiscal years 1987 and 1988); generally higher interest rates especially in 1987 and 1988 (7.4% to 7.8% on the 91-day Treasury bill rate and between 10% and 11% on the long-term government bond); higher unemployment rates (gradually declining to just under 7%); and somewhat higher inflation rates (rising to an average of 5% in 1987-1988 after remaining below 4% in 1985-1986) add $20.5 billion to the estimated deficit in FY1986, $25.6 billion in FY1987, and $39.2 billion in FY1988. The high deficits also add more interest expense, given the greater amount of outstanding debt that would result.

Thus, a more realistic estimate of the FY1988 deficit is near $174 billion, or 3.6% of GNP (Table 6). If this could be optimistic, since no recession is assumed to occur through 1988.

Table 6
Deficit Prospects: Reconciliation of Concurrent Budget Resolution and Shearson Lehman Projections
(Fiscal Years, Billions of Dollars)

	1985	1986	1987	1988
First Concurrent Resolution	209.8	171.9	154.7	112.9
Overstated Nondefense Savings*		9.9	12.2	21.5
Economic Reestimates*		20.5	25.6	39.2
Deficit Prospects*	209.8	202.3	192.5	173.6
Percent of GNP	5.5	4.9	4.3	3.6

*Shearson Lehman Economics estimates and forecast

The budget compromise is the half empty-half full cup of wine situation, an example of crisis management which has not been sufficient to fully resolve the problem. The concurrent budget resolution was better than nothing, but insufficient. A significant tightening of the budget was accomplished, with $21 billion of bona fide spending cuts in FY1986, $44.3 billion in FY1987, and $67.3 billion in FY1988, but not enough to permit a full rebalancing of the unbalanced policy mix that is at the heart of the current difficulties in the U.S. economy. The budget deficits are now on a declining path, and federal government spending, in real terms, will grow far more slowly in future years--about two percentage points or so less than if there had been no compromise. But the structural deficits still remain to keep interest rates higher, the dollar stronger, the trade deficit weaker, and trade debt increasing by more than otherwise would be the case.

The Economic Outlook (See Table 7 and Assumptions)

For the future, the current economic outlook, at best, suggests better growth in the U.S. economy over the next four quarters than the last, but with increasing risks of recession from the fallout of past imbalances in fiscal and monetary policies. Growth for real GNP is projected at 2% in 1985, fourth quarter-to-fourth quarter, and 2.9% in 1986, far less than Administration and Federal Reserve expectations. This pace of growth offers little hope for an end to the chronic problems that are besetting the U.S. and world economies. Inflation rates, while low, around 3% or so, will come under upward pressure in 1986 and beyond. The unemployment rate may yet rise from the current 7.1% and, in any case, is not likely to decline much. Pressure on corporate profits is likely to continue. And, the split performance of goods versus services activities seems set to continue.

More stopgap solutions to the problems stemming from large federal budget deficits, the strong dollar, chronic trade deficits, slow economic growth and sectoral imbalances--such as the recent G-5 Agreement--seem likely. But, although some signs of improvement should appear, the problems will not be resolved. Without a further correction of the unbalanced mix of fiscal and monetary policies, third and fourth best solutions can only delay what could be a losing battle in sustaining the economic expansion.

Recent data present a mixed set of signals on the economy. The data for July were almost uniformly bad, but showed that August and September were strong months. Consumer spending, durable goods orders and employment, especially in services, were considerably stronger. But, at the same time, the industrial sector of the economy continued to show only small signs of ending its long period of deterioration.

In the third quarter the real economy rebounded more than was suggested in the "flash" estimate of the Department of Commerce. Data since the report show a better trade balance than was assumed. Strong auto sales indicate more consumption than probably had been estimated. But inventories probably were lower. The net result should be a growth rate of about 3-1/2% or somewhat higher.

At issue is the staying power of the third quarter rebound. The bulk of the increase for real GNP occurred in consumption spending. The Commerce report on consumption for August indicated a surge in durable goods spending from much higher auto sales. Since the burst of auto sales likely resulted from temporary cut-rate financing, consumption spending rose much faster than income and the savings rate dropped to a 25-year low, it is likely that consumer spending will fade significantly in the fourth and first quarters.

Second, little change was estimated for business fixed investment by the Department of Commerce. If true, this is a distinct

Table 7
Shearson Lehman Economic and Financial Markets Forecast
October 15, 1985
Preliminary
(Probability=0.65)

	Quarters						Years				
	1985:2	1985:3	1985:4	1986:1	1986:2	1986:3	1984	1985	1986	1987	1988
Gross National Product-1972 Dollars	1671.3	1686.9	1698.6	1711.6	1725.0	1739.2	1639.3	1680.1	1730.7	1795.0	1867.7
Annual Rate of Change	1.9	3.8	2.8	3.1	3.2	3.3	6.8	2.5	3.0	3.7	4.0
Percent Change Year Ago	2.0	2.5	2.2	2.9	3.2	3.1	5.7	2.2	2.8	4.3	3.8
Consumption	1102.1	1117.3	1120.0	1125.4	1130.6	1136.7	1062.4	1107.1	1133.8	1175.2	1218.3
Annual Rate of Change	4.9	5.6	1.0	1.9	1.9	2.2	5.3	4.2	2.4	3.6	3.7
Business Fixed Investment	220.3	220.6	222.8	225.2	227.4	230.1	204.9	219.2	228.8	238.0	252.4
Annual Rate of Change	14.4	0.5	4.0	4.4	4.0	4.8	19.8	7.0	4.4	4.0	6.0
Residential Construction	60.9	60.8	61.5	62.1	61.7	61.3	60.2	60.8	61.8	63.5	66.6
Inventory Investment	8.3	0.2	6.8	8.5	9.1	7.6	24.8	8.6	7.6	5.8	9.0
Net Exports	-33.8	-32.3	-34.6	-31.2	-27.6	-20.4	-15.0	-32.3	-24.6	-14.8	-9.8
Government-											
Federal	129.7	136.8	137.2	136.4	137.9	137.7	122.6	133.1	137.2	138.9	140.2
Annual Rate of Change	-0.3	20.2	4.2	-2.3	4.5	-0.6	5.4	8.7	3.1	1.2	0.9
State and Local	183.9	184.5	184.9	185.2	185.9	186.2	179.6	183.6	186.1	188.5	191.0
Annual Rate of Change	6.8	1.3	0.9	0.7	1.5	0.6	2.2	2.2	1.4	1.3	1.3
Industrial Production (1977=1.000)	1.242	1.245	1.256	1.270	1.287	1.294	1.218	1.245	1.288	1.346	1.419
Annual Rate of Change	1.4	1.0	3.1	4.9	5.5	2.2	11.6	2.2	3.5	4.5	5.4
Housing Starts (Mil. Units)	1.772	1.721	1.745	1.783	1.786	1.704	1.767	1.758	1.760	1.820	1.906
Auto Sales-Total (Mil. Units)	10.9	12.4	9.4	10.2	10.6	10.7	10.4	10.9	10.6	10.9	11.1
Unemployment Rate-Civilian (%)	7.3	7.1	7.1	7.0	6.9	6.8	7.5	7.2	6.9	6.8	6.6
Federal Budget Surplus											
Unified (Quarterly Rate, NSA, FY)	-30.8	-45.8	-56.5	-68.3	-36.4	-41.1	-185.3	-206.9	-202.3	-192.6	-173.6
Implicit Price Deflator (%CH)	2.6	2.8	3.0	3.4	3.9	4.4	3.8	3.6	3.6	4.7	5.3
CPI- All Urban (%CH)	4.2	2.3	2.4	3.3	4.0	4.3	4.3	3.4	3.4	4.9	5.1
PPI-Finished Goods (%CH)	2.2	-0.7	2.3	3.1	3.5	3.6	2.1	0.8	2.5	4.8	5.1
Trade Weighted Exchange Rate	1.313	1.250	1.188	1.151	1.103	1.090	1.223	1.276	1.106	1.057	1.067
Annual Rate of Change	-10.8	-17.9	-18.4	-11.9	-15.7	-4.6	7.1	4.3	-13.3	-4.4	0.9
Corporate Profits Aftertax (Bils. $)	137.4	139.6	140.9	143.7	147.1	150.3	145.9	138.7	148.6	160.5	176.4
Percent Change Year Ago	-8.5	-1.5	-0.1	4.9	7.1	7.7	14.5	-4.9	7.1	8.0	9.9
Adjusted Profits Aftertax (Bil. $)	214.9	216.9	218.2	220.7	224.1	229.3	195.9	214.3	227.1	244.0	266.4
Percent Change Year Ago	10.1	8.6	7.0	6.6	4.3	5.7	31.1	9.4	6.0	7.4	9.2
Real Disposable Income	1205.3	1193.2	1199.4	1207.7	1217.0	1224.3	1168.0	1196.0	1219.9	1263.7	1319.9
Annual Rate of Change	8.2	-4.0	2.1	2.8	3.1	2.4	6.7	2.2	2.1	3.6	4.4
Personal Saving Rate (%)	5.1	2.7	2.8	3.0	3.2	3.1	6.1	3.8	3.1	3.3	3.7
M1 (Bils. $)	582.6	604.5	615.8	623.5	633.0	641.7	553.5	615.8	650.4	688.6	737.6
Annual Rate of Change	10.6	15.9	7.7	5.1	6.2	5.6	5.2	11.3	5.6	5.9	7.1
M2 (Bils. $)	2448.2	2510.9	2555.4	2597.8	2648.5	2698.8	2346.8	2555.4	2775.2	2936.6	3163.0
Annual Rate of Change	5.4	10.6	7.3	6.8	8.0	7.8	7.7	8.9	8.6	5.8	7.7
Federal Funds Rate (%)	7.92	7.90	7.59	7.46	7.58	7.60	10.23	7.97	7.60	7.66	8.04
Prime Rate (%)	10.20	9.50	9.35	9.10	9.25	9.60	12.04	9.90	9.49	9.82	10.42
New Top Quality Corporate Bonds (%)	11.78	11.29	11.15	10.84	11.06	11.21	12.44	11.56	11.14	11.25	11.32
30-Year Treasury Bond Rate (%)	10.98	10.56	10.39	10.19	10.31	10.42	12.39	10.80	10.36	10.66	10.91
Bond Buyer Index (%)	9.02	9.06	9.03	8.84	8.96	9.05	10.09	9.19	8.90	9.02	9.06
S&P Index of 500 Common Stocks	184.80	188.30	189.22	190.21	192.25	194.40	160.43	184.91	193.94	206.60	222.50
Annual Rate of Change	10.0	7.8	2.0	2.1	4.4	4.5	.0	15.3	4.9	6.5	7.7
Earnings Per Share - S&P 500 ($)	4.01	4.01	4.46	4.07	4.38	4.31	16.72	16.42	17.50	18.50	19.81
Price-Earnings Ratio - S&P 500	11.5	11.7	10.6	11.7	11.0	11.3	9.5	11.3	11.1	11.2	11.3

Forecast Assumptions:

Fiscal policy: The current forecast includes estimated budget savings from the First Concurrent Resolution passed prior to the Congressional recess for August. Shearson Lehman analyses indicate that nondefense savings were overstated by $9.9 billion, $12.3 billion, and $21.4 billion in 1986-1988. A portion of this amount is due to the implausibility of the Congress' assumption that it will pass legislation cutting income support to farmers in the midst of the most dramatic downturn in agriculture since the Great Depression. The exaggeration of savings also includes double-counting and unenforceable savings. It is important to note that the baseline estimates for defense used in the budget resolution were much too high. Thus, much of the defense savings ($34.6 billion in 1986, $33.8 billion in 1987, $41.9 billion in 1988) represents outlays that were unlikely to occur, regardless of Congressional action. This overstatement of defense savings does not affect the final deficit estimate--the baseline should have been lowered and the savings from the baseline reduced by the same amounts. But it does mean that the fiscal restraint that is actually being applied by the budget resolution, while significant, is not so great as is claimed. The combined effects of lower nondefense savings and less optimistic interest rate and real GNP growth rate assumptions lead to the following Shearson Lehman estimates of the deficit: $202.3 billion for FY1986; $188.8 billion for FY1987; and $173.4 billion for FY1988. The comparable budget resolution figures are $171.9 billion, $164.7 billion, and $112.9 billion.

Monetary policy: Accommodative to slightly easier through much of the rest of this year, with growth in the economy sluggish, monetary growth decelerating, and subdued rates of inflation. The excessive growth in M1 is finessed by support by the Federal Reserve of the G-5 agreement. All of this makes clear the central bank's concern with sustaining the expansion.

Policy mix: A modest and gradual change takes place in the "loose fiscal-tight money" policy mix that has characterized the economy--not enough to fully resolve the deficit dilemma and the imbalances that exist in trade, manufacturing, and the financial markets, but sufficient to prevent any major upward pressure on interest rates. The reductions in spending embodied in the FY1986 budget and the somewhat more accommodative stance of the Federal Reserve constitute the third twist in the policy mix over the last four years and suggest a lower profile of interest rates, a weaker dollar, and a better equity market than otherwise would have been the case.

Oil prices: As measured by refiners' acquisition costs, oil prices are assumed to drop another $1 to $2 a barrel over the next six months. OPEC oil production rises with seasonal demands, and Saudi Arabia increases production to 4.3 million barrels per day. Saudi netback arrangements reduce spot crude oil prices to near $26.50 per barrel by early spring.

Agricultural prices: Continuing weakness in most basic commodities and agricultural prices for the rest of this year, reflecting large supplies and the slack demands of weak economies throughout the world. Commodity prices begin to firm during 1986.

Wages and unit labor costs: In general, continuing downward pressure on wages from economic slack, the effects of deregulation, increased competition, and the decline in union strength. While contract negotiations should be slightly more favorable to labor this year and next, a tough stance by management is assumed to keep labor cost increases modest--about 3% per annum for this year and next.

Third World debt and bank problems: The debt problem is turning more critical. Mexico was out of compliance with its IMF program and in financial difficulty before earthquakes rocked Mexico City. At the United Nations, Latin American debtors blasted the IMF. Peru threatened to quit the Fund. With the IMF/World Bank annual meetings coming up, the debt crisis will become more visible. The bank-to-government via IMF dialogue may well be unravelling in favor of more government-to-government discussions. LDC debt and its fallout is a constraint to growth.

Growth in the rest-of-the-world economies: The economic expansion in developed countries is expected to be sustained through 1985 and 1986. European countries continue to grow at moderate rates of about 3% to 3-1/2%, with some improvement for inflation but little on the unemployment front. Growth rates in Canada and Japan will exhibit a slowdown in 1985 and 1986 as a result of a slowdown in U.S. economic growth, but will remain relatively high--at about 4% to 5%. Likewise, Far Eastern countries such as Taiwan, Singapore, Korea, and Hong Kong--highly dependent on exports--will suffer as a result of declining U.S. imports in late 1985 and 1986. Latin American countries will also be affected by reduced U.S. imports but, excluding Mexico, will show a small but positive growth.

Alternative possibilities and probabilities: An alternative to the baseline (Higher Rates Scenario, probability = 10%) assumes above-target money growth and strong economic growth in the second half of the year. The higher monetary growth is associated with higher inflation and higher interest rates, which push the economy into a recession by the latter part of 1986. A second alternative (Fizzling Out Scenario, probability = 15%) assumes that the economy fades into recession this year, fizzling out from weak foreign trade, slack in consumer spending, and too long a delay in easing by the central bank. Once the recession occurs, monetary growth eases and the Fed aggressively loosens policy. Interest rates decline by one to two percentage points over the next year in this scenario. Finally, a third projection (Lower Inflation Scenario, probability = 5%) assumes a sharp decline in oil prices that leads to lower inflation, reductions of interest rates, and higher growth rates than in the baseline forecast.

Trade legislation and tax reform: The G-5 agreement is assumed to result in coordinated periodic interventions against the dollar--mostly by Japan and West Germany--speeding up and intensifying the dollar decline that began in late February. A slight notch of easing late in the year by the U.S. central bank, after monetary growth eases, helps to keep the dollar down to levels near 2.5 deutschemarks, 210 to 215 yen, and 8 French francs--levels to which the dollar would have fallen anyway, but not until next year.

negative for the economy. If consumption spending should fade in the fourth quarter and beyond, then it is hard to see how business fixed investment can improve much.

Finally, inventory accumulation was down in the third quarter compared with the second, undoubtedly the result of a decumulation of auto inventories. Since 1986 auto sales have been borrowed against in exchange for third quarter sales, auto makers may well be caught with excess inventories in relation to sales in the new model year, and cut back later.

As Table 8 shows, consumers are heavily in debt, with outstanding debt relative to income at postwar highs and delinquency rates on mortgage and installment credit sharply higher. With the personal saving rate below 3%, some retrenchment in consumption is inevitable. What is keeping household spending and borrowing up appears to be still reasonable monthly loan repayments, both for mortgages and auto loans, relative to income, compared with historical experience. But, with these financial statistics, consumer spending almost certainly will fade.

For the fourth quarter, growth is likely to weaken to about a 2-1/2% pace, reflecting a slowdown in consumer spending and less improvement for net exports, if any, compared with the third quarter. Stronger growth may well be generated by a rebound of inventories, but this would be a sign of weakness rather than strength, especially if inventories were built up in the automotive sector.

The Shearson Lehman economic forecast presents a "muddling-through" scenario for the next couple of years. The expansion should continue, getting a second wind from lower inflation, lower interest rates, and a lower dollar. If all else fails, the central bank will step in to keep the economy expanding. The harmful effects of recession in the U.S. and world economies far outweigh the risk of reinflation. Sustained growth thus is likely, but probably subpar in 1985 and 1986, with a one-in-four risk from recession.

The reduced inflation, lower interest rates, lower dollar, and accommodative Federal Reserve policy envisioned do not insure growth in the 3% to 4% range and a decline of unemployment, however. More of a fundamental correction in the policy mix is required.

For next year, an improvement in net exports should contribute most to improved growth, with only modest increases for consumption spending and business fixed investment. Housing and residential construction are expected to be firm, but not to rise much. Business will keep inventories lean in relation to sales. And, federal government spending is forecast at a 3.1% annual rate, compared with 8.7% in 1985.

Table 8
Consumer Behavior: Financial Indicators

	Quarters			Years*			
	1988:3F	1988:2	1988:1	1984	1980	1970	1960
Consumer Indebtedness							
Consumer Credit, Total**	672.2	644.0	614.7	548.1	385.1	141.3	63.6
(% change, annual rate)	18.7	20.5	549.3	9.2	10.5	11.8	--
(as a % of disposable income)	24.8	23.6	23.2	21.3	21.1	20.3	18.1
Installment Credit	540.0	517.1	493.0	517.1	311.2	104.1	43.9
(% change, annual rate)	18.9	21.0	22.4	13.5	11.6	9.0	--
(as a % of disposable income)	19.9	19.0	18.6	17.0	17.0	15.0	12.5
Other Consumer Credit	132.2	127.0	121.6	109.6	73.9	37.2	19.7
(% change, annual rate)	17.6	18.7	20.7	10.4	7.1	6.6	--
(as a % of disposable income)	4.9	4.7	4.6	4.3	4.0	5.3	5.6
Home Mortgages	1449.1	1407.7	1372.9	1281.3	930.5	284.9	133.1
(% change, annual rate)	12.3	10.5	9.9	8.3	12.6	7.9	--
(as a % of disposable income)	53.4	51.6	51.7	49.7	50.9	41.0	37.8
TOTAL	2121.3	2051.7	1987.6	1829.4	1315.6	426.2	196.6
(% change, annual rate)	14.3	13.6	13.5	8.6	11.9	8.0	--
(as a % of disposable income)	78.2	75.3	74.9	71.0	71.9	61.3	55.9
Debt Service							
Mortgage Repayments ($ per month)	709	729	738	702	584	140	84
(as a % of median family income)	29.8	31.1	32.1	31.9	33.3	17.0	18.0
Newly-Built Homes							
Fixed Rate	639	705	719	684	--	--	--
Adjustable Rate	603	649	655	659	--	--	--
Existing Homes							
Fixed Rate	610	626	634	616	--	--	--
Adjustable Rate	570	581	590	590	--	--	--
Auto Loan Repayments ($ per month)	250	242	243	253	183	161	--
(as a % of median family income)	10.5	10.3	10.6	11.5	10.5	19.5	--
Interest Payments on Installment Credit as a % of Disposable Income	3.4	3.3	3.2	3.2	2.5	1.6	1.1
Interest Payments on Mortgages as a % of Disposable Income	7.2	7.2	7.2	7.3	5.6	3.6	2.5
Interest Payments on All Debt as a % of Disposable Income	10.6	10.5	10.4	10.4	8.1	5.2	3.6
Delinquency Rates							
Installment Credit (%)	2.35	2.32	2.26	1.96	2.61	--	--
Mortgages (%)	6.40	6.30	6.19	5.66	4.98	3.13	2.41
Other Household Measures							
Financial Assets/Liabilities	250.9	250.6	252.3	251.4	237.7	340.0	385.8
Real Financial Assets	2334.1	2302.2	2249.6	2157.3	1811.9	1566.1	1080.7
(% change, annual rate)	5.7	9.6	18.3	4.5	1.5	3.8	--
Net Worth (net of depreciation)	12390.0	12142.0	11951.2	11660.5	8933.0	3171.0	1751.7
(% change, annual rate)	8.4	6.5	10.4	6.9	10.9	6.1	--
Real Net Worth (net of dep'n)	5434.2	5367.6	5321.1	5233.6	4763.5	2947.8	2411.8
(% change, annual rate)	5.1	3.5	6.9	2.4	4.9	2.0	--

F=Shearson Lehman Brothers forecast.

*Percent change is as of the previous indicated year, at an annual rate.

**Consumer credit includes short- and intermediate-term installment and noninstallment credit extended to individuals through regular business channels to finance the purchase of consumer goods and services.

Inflation rates are expected to fluctuate between 3% and 3-1/2%, tilting upward as 1986 progresses because of a lower dollar. The dollar should drop another 10% or so from current levels over the next year, reflecting negative fundamentals and periodic intervention by the G-5 countries. Profits are forecast to do better in 1986 than 1985, rising by about 7% because of cost cutting, earnings translation under a weaker dollar, and improved sales. The projections also show monetary growth moving to within target ranges for the next year and interest rates stable to somewhat lower. Stock prices enjoy a modest rise as a result.

How can the expansion continue? The economic slowdown has not been all bad; indeed, it has probably enhanced the potential for sustained, albeit subpar, growth. By-products include lower inflation, lower interest rates, and a lower dollar which, in turn, enhance the prospects for future growth. The growth recession has opened up more slack in the economy, adding to downward pressure on prices and wages. Ample supplies of food commodities and less demand for oil imports also have helped to drive prices down. The slowdown has been associated with lower interest rates, with demand-side weakness bringing declines as well as periodic easings of monetary policy. Finally, a lower dollar is a consequence of slow growth and the reductions of interest rates that have occurred.

Lower inflation enhances household and business purchasing power; lower interest rates increase the affordability of durable goods and reduce the costs of financing for households; and the lower dollar should, with lags, act to reduce imports and increase exports. All of these are necessary in order for the expansion to be sustained.

The relatively sanguine forecast of sustained growth depends on a number of critical assumptions, most having to do with economic policy.

First, it is assumed that the budget tightening of the past summer results in slowed economic and monetary growth, thus permitting more leeway for the Federal Reserve to be accommodative or to ease somewhat to sustain growth. Second, the Federal Reserve is assumed to ease later this year, helping to reduce real interest rates and the dollar another notch. This assumption is open to question, however, given the rapid decline in the dollar already and the growing potential for a dollar-induced reinflation. The central bank fears this eventuality. Third, no major protectionist legislation is assumed, a somewhat risky view unless the U.S. industrial sector improves greatly over the next year. Fourth, tax reform is assumed to be neutral in its impacts on macroeconomic growth. The risk is that as it currently stands, the tax increases for business in the proposed legislation could bring a major slowdown in the first year of passage. Fifth, the G-5 intervention is assumed to accelerate the decline of the dollar, since the dollar would have dropped anyway, helping to speed a turnaround in foreign trade.

However, the risk here is that without underlying fundamental reforms in the monetary and fiscal policies of the United States and rest of the world, no lasting improvement can occur for the U.S. industrial sector. Sixth, it is assumed that weakness in the goods sectors is not carried over into the services sectors, so services activities can keep carrying the economy higher. Seventh, oil prices are expected to decline further, offsetting the potential reinflationary effects from a weaker dollar.

Risks of Recession, Potential Impacts on the Budget, and Effects on the Debt Burden

There are a lot of "ifs" in the forecast, so much so that the risk of recession must be regarded as one-in-four. How would a recession arise? One way is through a fizzling out, a fading into a downturn as demands weaken and the competitive pressures on the tradable goods sector take their toll. The other eventuality leading to a recession would be a dollar collapse, stronger growth than expected because of improving net exports, excessive monetary growth, accelerated inflation, higher interest rates, and restriction by the Federal Reserve.

With the economy about to enter the fourth year of expansion, the possibility of a recession is well within the historical averages. For the postwar period, the average length for expansions has been 44.3 months. Excluding war years, the average length is near 34 months.

So far, the classic characteristics that precede a recession are not present. These include, but are not limited to, output nearing capacity, bottlenecks and shortages, upward pressure on prices and wages, heavy credit demands, rising interest rates, a tightening of Federal Reserve policy, rising inventory:sales ratios, and often a credit crunch. Currently, the only excess that has been present has been a mild accumulation of unwanted inventories, which has been in the process of correction now for some months.

A more traditional pattern could arise in the current environment, however, through the mechanism of the dollar, international trade, and international finance. The decline in the dollar might turn into a freefall, if foreign holders of dollar-denominated assets begin to turn away from the currency. This can happen because of expectations that the dollar is headed lower, out of disenchantment with the prospects for the U.S. economy, from improved prospects in other countries, or a resurgence of inflation from the dollar decline itself with lags, the declines in the dollar with lags should produce increased real economic growth through a turnaround in foreign trade and also higher inflation. The extent of the inflation reaction from a lower dollar is uncertain, but it is now becoming better known that the disinflation of the past five years was very much an effect of a strong dollar, suggesting a possible sharp upward effect.

Increased real economic growth and higher inflation could fuel a surge in monetary growth, forcing the central bank to tighten monetary policy. In this situation, many of the traditional pre-recession features would arise. A recession would likely occur in late 1986 or early 1987, worsening the deficits further.

Table 9 shows the sensitivity of federal budget deficits to changes in real economic growth, inflation, the unemployment rate, and interest rates, as estimated by Shearson Lehman Economics.

Table 9
Impacts of Growth, Inflation, Interest Rates, and the Unemployment Rate on Budget Deficits
(Billions of Dollars, Fiscal Years)*

	1986	1987	1988
Case 1	4.4	13.0	15.6
Case 2	4.4	18.6	37.0
Case 3	3.6	8.0	8.1
Case 4	3.6	12.1	21.3
Case 5	2.6	5.0	5.2
Case 6	3.0	9.0	14.0

Case 1 = 1% more real GNP growth, one time, 1986:4 over 1985:4.
Case 2 = 1% more real GNP growth in each year.
Case 3 = 1% more inflation, one time, 1986:4 over 1985:4.
Case 4 = 1% more inflation every year.
Case 5 = 1 percentage point lower unemployment rate starting in 1986:1 but no change in real GNP.
Case 6 = 1% percentage point lower interest rates in each year, 1986 to 1988.

* Positive figures represent reductions in the deficit.

Weaker real economic growth can be seen to have the biggest impact on the budget deficits. Real economic growth of two to three percentage points less over the next three years would raise the budget deficits by anywhere from about $10 billion in FY1986 to $75 billion in FY1988. The higher inflation would reduce the budget deficits, however, offsetting some 50% to 60% of the worsening. Higher interest rates, perhaps two to four percentage points under a tighter monetary policy, would raise the deficits significantly. All-in-all, under the traditional path to a recession by late 1986 or 1987, the FY1988 budget deficit might reach $250 billion to $270 billion.

Budget Deficits, Policy Mix, and Economic Impacts

As an approximation to the potential effects of further reductions in the budget deficits, such as might be embodied in the Gramm-Rudman amendment to the debt ceiling bill, the Shearson Lehman Model of the U.S. Economy was used to simulate the impacts of reductions in the deficits over the next few years, achieved through changes in spending. Table 10 summarizes the results.

Table 10
Effects on U.S. Economy from Spending Cuts:
Fiscal Years 1986 to 1988*
(Changes from the Baseline, No Compensating Fed Ease)

	1986	1987	1988
Federal Govt. Spending (Bils. Dols.)	-33	-66	-105
Real GNP (% Chg.)	-1.0	-0.7	-0.6
Final Demands (Bils. 72 Dols.)			
Consumption	-2.0	-4.9	-8.2
Bus. Invest.	0.1	0.8	2.1
Net Exports	1.3	6.6	11.2
Housing Starts (Mils. Units)	.008	.020	.070
AAA-Equivalent Bond Yield (Basis Points)	-60	-115	-169
Federal Funds Rate (Basis Points)	-17	-85	-182
Deficit (Bils. Dols.)	-26.6	-48.2	-75.8

*Computer simulations with the Shearson Lehman Model of the U.S. Economy. Computer simulations with an econometric model should be regarded as producing an approximate outcome--the central tendency of a distribution of possibilities given the change in policy and structure of the economy as assumed in the model, provided that the policy shock is within the range of historical experience.

The reductions in federal government spending necessary to close the deficit gap, after feedback, range from $33 billion in 1986

- Between November 1982 and currently, manufacturing employment has increased by 1.2 million persons; mining employment is down 70,000 persons; and agricultural employment has dropped 507,000 persons. Since January, total employment in the goods sectors of the U.S. economy is down 163,000 and manufacturing employment has dropped by 338,000 persons. Services employment, on the other hand, has grown robustly, rising by 7.5 million persons since the expansion began and a large 1.9 million persons since January. A split personality has developed for the U.S. economy, with essentially a recession in most goods-producing industries and a near boom in services.

- After an extraordinary rise of 55.9% from July 1980 to March 1985, the dollar is now declining sharply, raising the potential for higher inflation in coming months. Since its high in February, the dollar has dropped 15.5% against the Morgan Guaranty trade-weighted average of foreign currencies. Since the G-5 Agreement, the dollar is down about 5-1/2%.

- From 1982:4 to mid-1984, after-tax corporate profits rose a large 49.4%. Since last year, after-tax corporate profits are down by 8.3%.

- Between the fourth quarter of 1982 and mid-1984, real disposable income rose 9.2%. Since last summer, real disposable income is up by only 3.4%.

- Numerous business and financial institutions are in a fragile condition, with high interest rates for so long, the too high dollar, disinflation, and intense foreign competition contributing to a large number of failures in agriculture, business institutions, and financial institutions.

- Finally, over the past year, the U.S. economy has exhibited a growth recession, growing at less than potential output in three of the past four quarters.

Table 1
"Growth Recessions" in the Postwar Period*

Dates	Quarters Into Expansion	Growth	Recession (R) or Continued Expansion (E)	Quarters Until Recession
1951:4 to 1952:2	8	0.8, 3.2, 0.4	R	5
1956:1 to 1956:3	7	-1.6, 2.1, 0.3	R	2
1967:1 to 1967:2	25	0.5, 2.6	E	11
1973:2 to 1973:3	10	0.5, 2.6	R	1
1976:2 to 1976:3	5	2.7, 2.3	E	14
1984:3 to 1985:2	10	1.6, 4.2, 0.3, 1.9 (Average, 2.0)	?	?

*Two or more quarters of less-than-potential growth in GNP.

The economy also is showing a growing adverse split of nominal GNP between growth and inflation. Earlier, real growth was exceptionally strong and inflation rates were low. Now, a greater proportion of nominal GNP is in inflation and a smaller one for growth (Chart 1 above).

The Budget Outlook

Unfortunately, not enough was done in this year's budget tightening to fully resolve the deficit dilemma. Although almost as big a dose of restriction occurred, as in the TEFRA tax hike in 1982, the bona fide budget savings are far less than indicated and the projections of deficits are understated (Tables 2-6).

Table 2
Comparison of Savings From Deficit Resolution
Packages in Recent Years*
(Billions of Dollars, Fiscal Years)

	Year 1	Year 2	Year 3	Total
1982, TEFRA	21.7	43.6	50.6	115.5
1984, DEFRA	10.6	16.5	22.5	49.5
1985, Reconciliation Act (Anticipated)	17.8	22.5	30.5	70.8
1985, Reconciliation Plus Defense	20.7	34.2	51.1	106.0
1985, Bona Fide Savings Except Debt Service	19.4	36.6	49.0	105.0

*Shearson Lehman Economics

The savings claimed in the Congressional Budget Resolution was $55.5 billion in FY1986, $90 billion in FY1987 and $130.7 billion in FY1988 -- $276.2 billion over three years. The savings claimed in the Budget Resolution consists of $27.5 billion in defense outlays and $25.3 billion in nondefense spending for FY1986, cumulating to $137.3 billion in defense savings and $108.6 billion in nondefense savings over the next three years. Lower debt service costs save $2.7 billion in FY1986 and $30.3 billion between 1986 and 1988. 49.7% of the alleged savings are in defense, 39.3% in nondefense, and 11% in reduced interest costs.

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[2] James Capra and Allen Sinai, "Deficit Prospects: Half Empty or Half Full?" Shearson Lehman Brothers Economic Studies Series No. 14, October 1, 1985.

These savings are overstated, however. Shearson Lehman estimates show that bona fide budget savings of only $21 billion can be expected for FY1986[2]. For all three years covered, the budget savings are $132.6 billion rather than the $276.2 billion indicated by the Congressional Budget Resolution. The difference is due to questionable savings in nondefense as well as overestimates of the baseline starting point, and, by extension, the savings for defense. Table 3 shows the Shearson Lehman estimates of the real savings in the current Budget Resolution.

Table 3
Bona Fide Budget Savings*
(Fiscal Years, Billions of Dollars)

	1986	1987	1988	Total
Budget Resolution	55.5	90.9	130.7	276.2
Nondefense	25.3	35.4	47.9	108.6
Defense	27.5	45.2	64.6	137.3
Debt Service	2.7	9.4	18.2	30.3
Questionable Savings	34.5	45.7	67.3	147.5
Nondefense	9.5	10.8	18.6	38.9
Defense	24.6	33.5	45.9	104.0
Debt Service	0.4	1.4	2.8	4.6
Savings	21.0	44.3	67.3	132.6

*Shearson Lehman estimates.

The federal budget deficits are projected by the budget resolution to steadily decline from $209.8 billion in 1985 to $171.9 billion in 1986, and eventually to $112.9 billion in 1988 (Table 4). If these figures are correct, there would be a dramatic shift in the fiscal posture of the federal government. A deficit of $209.8 billion for 1985 represents 5.5% of nominal GNP. A $112 billion deficit, under the assumptions used by the budget conferees, would equal 2.3% of GNP. The decline in the deficit: GNP ratio would be almost as large and would occur as quickly as the escalation of that ratio between 1980 and 1983, when the deficit rose from 2.9% to 6.4% of GNP.

Unfortunately, the deficits projected in the budget resolution are too low. Questionable savings in nondefense add $9.9 billion, $12.2 billion, and $21.5 billion to the deficits in FY1986 to FY1988.

In addition, the relatively optimistic economic assumptions on growth (4% per year), the unemployment rate (steady declines to 6.4%), and interest rates (5.9% on the three-month Treasury bill rate by FY1988 and 7.8% for the long-term Treasury bond) used by the budget conferees are a major source of the underestimated deficits.

Table 4

Congressional Budget Resolution: Deficits and Assumptions*

(Fiscal Years, Billions of Dollars Except
as Otherwise Indicated)

	1985	1986	1987	1988
Revenues	736.5	795.7	869.4	960.2
Outlays	946.3	967.6	1024.1	1073.0
Deficits	209.8	171.9	154.7	112.9
Deficits/GNP (Percent)	5.5	3.8	3.1	2.3
Economic Assumptions				
Real GNP (Percent Change)	4.0	4.0	4.0	4.0
Implicit GNP Deflator (Percent Change)	3.6	4.3	4.2	4.0
Unemployment Rate (Percent, FY Average)	7.0	6.9	6.7	6.4
91-Day Treasury Bills (Percent)	7.6	7.5	7.0	5.9
Long-Term Government Bond (Percent)	11.3	10.5	9.7	7.8

*Estimates contained in the concurrent resolution and the conference agreement.

Table 5

Shearson Lehman Budget Projections and Assumptions

(Fiscal Years, Billions of Dollars Except
as Otherwise Indicated)

	1985	1986	1987	1988
Revenues	737.0	774.0	844.5	941.6
Outlays	943.9	976.3	1037.0	1115.2
Deficits	209.8	202.3	192.5	173.6
Deficits/GNP (Percent)	5.5	4.9	4.3	3.6
Economic Assumptions				
Real GNP (Percent Change)	2.4	2.9	3.5	4.1
Implicit GNP Deflator (Percent Change)	3.7	3.9	4.8	5.3
Unemployment Rate (Percent, FY Average)	7.4	7.2	7.0	6.8
91-Day Treasury Bills (Percent)	7.5	7.4	7.5	7.8
Long-Term Government Bond (Percent)	11.2	10.5	10.8	11.1

Economic reestimates, based on Shearson Lehman economic forecasts, shown in Table 5, of slower growth (2.4% real growth in 1985, 2.9% for 1986 and above potential growth in fiscal years 1987 and 1988); generally higher interest rates especially in 1987 and 1988 (7.4% to 7.8% on the 91-day Treasury bill rate and between 10% and 11% on the long-term government bond); higher unemployment rates (gradually declining to just under 7%); and somewhat higher inflation rates (rising to an average of 5% in 1987-1988 after remaining below 4% in 1985-1986) add $20.5 billion to the estimated deficit in FY1986, $25.6 billion in FY1987, and $39.2 billion in FY1988. The high deficits also add more interest expense, given the greater amount of outstanding debt that would result.

Thus, a more realistic estimate of the FY1988 deficit is near $174 billion, or 3.6% of GNP (Table 6). If this could be optimistic, since no recession is assumed to occur through 1988.

Table 6
Deficit Prospects: Reconciliation of Concurrent
Budget Resolution and Shearson Lehman Projections
(Fiscal Years, Billions of Dollars)

	1985	1986	1987	1988
First Concurrent Resolution	209.8	171.9	154.7	112.9
Overstated Nondefense Savings*		9.9	12.2	21.5
Economic Reestimates*		20.5	25.6	39.2
Deficit Prospects*	209.8	202.3	192.5	173.6
Percent of GNP	5.5	4.9	4.3	3.6

*Shearson Lehman Economics estimates and forecast

The budget compromise is the half empty-half full cup of wine situation, an example of crisis management which has not been sufficient to fully resolve the problem. The concurrent budget resolution was better than nothing, but insufficient. A significant tightening of the budget was accomplished, with $21 billion of bona fide spending cuts in FY1986, $44.3 billion in FY1987, and $67.3 billion in FY1988, but not enough to permit a full rebalancing of the unbalanced policy mix that is at the heart of the current difficulties in the U.S. economy. The budget deficits are now on a declining path, and federal government spending, in real terms, will grow far more slowly in future years--about two percentage points or so less than if there had been no compromise. But the structural deficits still remain to keep interest rates higher, the dollar stronger, the trade deficit weaker, and trade debt increasing by more than otherwise would be the case.

The Economic Outlook (See Table 7 and Assumptions)

For the future, the current economic outlook, at best, suggests better growth in the U.S. economy over the next four quarters than the last, but with increasing risks of recession from the fallout of past imbalances in fiscal and monetary policies. Growth for real GNP is projected at 2% in 1985, fourth quarter-to-fourth quarter, and 2.9% in 1986, far less than Administration and Federal Reserve expectations. This pace of growth offers little hope for an end to the chronic problems that are besetting the U.S. and world economies. Inflation rates, while low, around 3% or so, will come under upward pressure in 1986 and beyond. The unemployment rate may yet rise from the current 7.1% and, in any case, is not likely to decline much. Pressure on corporate profits is likely to continue. And, the split performance of goods versus services activities seems set to continue.

More stopgap solutions to the problems stemming from large federal budget deficits, the strong dollar, chronic trade deficits, slow economic growth and sectoral imbalances--such as the recent G-5 Agreement--seem likely. But, although some signs of improvement should appear, the problems will not be resolved. Without a further correction of the unbalanced mix of fiscal and monetary policies, third and fourth best solutions can only delay what could be a losing battle in sustaining the economic expansion.

Recent data present a mixed set of signals on the economy. The data for July were almost uniformly bad, but showed that August and September were strong months. Consumer spending, durable goods orders and employment, especially in services, were considerably stronger. But, at the same time, the industrial sector of the economy continued to show only small signs of ending its long period of deterioration.

In the third quarter the real economy rebounded more than was suggested in the "flash" estimate of the Department of Commerce. Data since the report show a better trade balance than was assumed. Strong auto sales indicate more consumption than probably had been estimated. But inventories probably were lower. The net result should be a growth rate of about 3-1/2% or somewhat higher.

At issue is the staying power of the third quarter rebound. The bulk of the increase for real GNP occurred in consumption spending. The Commerce report on consumption for August indicated a surge in durable goods spending from much higher auto sales. Since the burst of auto sales likely resulted from temporary cut-rate financing, consumption spending rose much faster than income and the savings rate dropped to a 25-year low, it is likely that consumer spending will fade significantly in the fourth and first quarters.

Second, little change was estimated for business fixed investment by the Department of Commerce. If true, this is a distinct

Table 7
Shearson Lehman Economic and Financial Markets Forecast
October 15, 1985
Preliminary
(Probability=0.65)

	Quarters						Years				
	1985:2	1985:3	1985:4	1986:1	1986:2	1986:3	1984	1985	1986	1987	1988
Gross National Product-1972 Dollars	1671.3	1686.9	1698.6	1711.6	1725.0	1739.2	1639.3	1680.1	1730.7	1795.6	1867.7
Annual Rate of Change	1.9	3.8	2.8	3.1	3.2	3.3	6.8	2.5	3.0	3.7	4.0
Percent Change Year Ago	2.0	2.5	2.2	2.9	3.2	3.1	5.7	2.2	2.8	4.3	3.8
Consumption	1102.1	1117.3	1120.0	1125.4	1130.6	1136.7	1062.4	1107.1	1133.8	1175.2	1218.3
Annual Rate of Change	4.9	5.6	1.0	1.9	1.9	2.2	5.3	4.2	2.4	3.6	3.7
Business Fixed Investment	220.3	220.6	222.8	225.2	227.4	230.1	204.9	219.2	228.8	238.0	252.4
Annual Rate of Change	14.4	0.6	4.0	4.4	4.0	4.8	19.8	7.0	4.4	4.0	6.0
Residential Construction	60.9	60.8	61.5	62.1	61.7	61.3	60.2	60.8	61.8	63.5	66.6
Inventory Investment	8.3	0.2	6.8	8.5	9.1	7.6	24.8	8.6	7.6	5.8	9.0
Net Exports	-33.8	-32.3	-34.6	-31.2	-27.6	-20.4	-15.0	-32.3	-24.6	-14.8	-9.8
Government-											
Federal	129.7	135.8	137.2	136.4	137.9	137.7	122.5	133.1	137.2	138.9	140.2
Annual Rate of Change	-0.3	20.2	4.2	-2.3	4.5	-0.6	5.4	8.7	3.1	1.2	0.9
State and Local	183.9	184.5	184.9	185.2	185.9	186.2	179.6	183.6	186.1	188.5	191.0
Annual Rate of Change	6.8	1.3	0.9	0.7	1.5	0.6	2.2	2.2	1.4	1.3	1.3
Industrial Production (1977=1.000)	1.242	1.245	1.256	1.270	1.287	1.294	1.218	1.245	1.288	1.346	1.419
Annual Rate of Change	1.4	1.0	3.1	4.9	5.5	2.2	11.6	2.2	3.5	4.5	5.4
Housing Starts (Mil. Units)	1.772	1.721	1.745	1.783	1.765	1.704	1.767	1.758	1.760	1.820	1.906
Auto Sales-Total (Mil. Units)	10.9	12.4	9.4	10.2	10.6	10.7	10.4	10.9	10.6	10.9	11.1
Unemployment Rate-Civilian (%)	7.3	7.1	7.1	7.0	6.9	6.8	7.5	7.2	6.9	6.8	6.6
Federal Budget Surplus											
Unified (Quarterly Rate, NSA, FY)	-30.8	-45.8	-56.5	-68.3	-36.4	-41.1	-185.3	-206.9	-202.3	-192.6	-173.6
Implicit Price Deflator (%CH)	2.6	2.8	3.0	3.4	3.9	4.4	3.8	3.6	3.6	4.7	5.3
CPI- All Urban (%CH)	4.2	2.3	2.4	3.3	4.0	4.3	4.3	3.4	3.4	4.9	5.1
PPI-Finished Goods (%CH)	2.2	-0.7	2.3	3.1	3.5	3.6	2.1	0.8	2.5	4.8	5.1
Trade Weighted Exchange Rate	1.313	1.250	1.188	1.151	1.103	1.090	1.223	1.276	1.106	1.057	1.067
Annual Rate of Change	-10.8	-17.9	-18.4	-11.9	-15.7	-4.6	7.1	4.3	-13.3	-4.4	0.9
Corporate Profits Aftertax (Bils. $)	137.4	139.6	140.9	143.7	147.1	150.3	145.9	138.7	148.6	160.5	176.4
Percent Change Year Ago	-8.5	-1.5	-0.1	4.9	7.1	7.7	14.5	-4.9	7.1	8.0	9.9
Adjusted Profits Aftertax (Bil. $)	214.9	216.9	218.2	220.7	224.1	229.3	195.9	214.3	227.1	244.0	266.4
Percent Change Year Ago	10.1	8.6	7.0	6.6	4.3	5.7	31.1	9.4	6.0	7.4	9.2
Real Disposable Income	1205.3	1193.2	1199.4	1207.7	1217.0	1224.3	1169.0	1195.0	1219.9	1263.7	1319.9
Annual Rate of Change	8.2	-4.0	2.1	2.8	3.1	2.4	6.7	2.2	2.1	3.6	4.4
Personal Saving Rate (%)	5.1	2.7	2.8	3.0	3.2	3.1	6.1	3.8	3.1	3.3	3.7
M1 (Bils. $)	582.6	604.5	615.8	623.5	633.0	641.7	553.6	615.8	650.4	688.6	737.6
Annual Rate of Change	10.6	15.9	7.7	5.1	6.2	5.6	5.2	11.3	6.6	5.9	7.1
M2 (Bils. $)	2448.2	2510.9	2555.4	2597.8	2648.5	2698.8	2345.8	2555.4	2775.2	2936.6	3163.0
Annual Rate of Change	5.4	10.6	7.3	6.8	8.0	7.8	7.7	8.9	8.6	5.8	7.7
Federal Funds Rate (%)	7.92	7.90	7.59	7.46	7.58	7.60	10.23	7.97	7.60	7.66	8.04
Prime Rate (%)	10.20	9.50	9.35	9.10	9.25	9.60	12.04	9.90	9.49	9.82	10.42
New Top Quality Corporate Bonds (%)	11.78	11.29	11.15	10.84	11.06	11.21	12.44	11.56	11.14	11.25	11.32
30-Year Treasury Bond Rate (%)	10.99	10.56	10.39	10.19	10.31	10.42	12.39	10.88	10.36	10.66	10.91
Bond Buyer Index (%)	9.02	9.06	9.03	8.84	8.96	9.06	10.09	9.19	8.99	9.02	9.06
S&P Index of 500 Common Stocks	184.80	188.30	189.22	190.21	192.25	194.40	160.43	184.91	193.94	206.60	222.50
Annual Rate of Change	18.0	7.8	2.0	2.1	4.4	4.5	.0	15.3	4.9	6.5	7.7
Earnings Per Share - S&P 500 ($)	4.01	4.01	4.46	4.07	4.38	4.31	16.72	16.42	17.50	18.50	19.81
Price-Earnings Ratio - S&P 500	11.5	11.7	10.6	11.7	11.0	11.3	9.5	11.3	11.1	11.2	11.3

Forecast Assumptions:

Fiscal policy: The current forecast includes estimated budget savings from the First Concurrent Resolution passed prior to the Congressional recess for August. Shearson Lehman analyses indicate that nondefense savings were overstated by $9.9 billion, $12.2 billion, and $21.4 billion in 1986-1988. A portion of this amount is due to the implausibility of the Congress' assumption that it will pass legislation cutting income support to farmers in the midst of the most dramatic downturn in agriculture since the Great Depression. The exaggeration of savings also includes double-counting and unenforceable savings. It is important to note that the baseline estimates for defense used in the budget resolution were much too high. Thus, much of the defense savings ($26.6 billion in 1986, $33.8 billion in 1987, $41.9 billion in 1988) represents outlays that were unlikely to occur, regardless of Congressional action. This overstatement of defense savings does not affect the final deficit estimate--the baseline should have been lowered and the savings from the baseline reduced by the same amounts. But it does mean that the fiscal restraint that is actually being applied by the budget resolution, while significant, is not so great as is claimed. The combined effects of lower nondefense savings and less optimistic interest rate and real GNP growth rate assumptions lead to the following Shearson Lehman estimates of the deficit: $202.3 billion for FY1986; $198.5 billion for FY1987; and $173.6 billion for FY1988. The comparable budget resolution figures are $171.9 billion, $164.7 billion, and $112.9 billion.

Monetary policy: Accommodative to slightly easier through much of the rest of this year, with growth in the economy sluggish, monetary growth decelerating, and subdued rates of inflation. The excessive growth in M1 is finessed by support by the Federal Reserve of the G-5 agreement. All of this makes clear the central bank's concern with sustaining the expansion.

Policy mix: A modest and gradual change takes place in the "loose fiscal-tight money" policy mix that has characterized the economy--not enough to fully resolve the deficit dilemma and the imbalances that exist in trade, manufacturing, and the financial markets, but sufficient to prevent any major upward pressure on interest rates. The reductions in spending embodied in the FY1986 budget and the somewhat more accommodative stance of the Federal Reserve constitute the third twist in the policy mix over the last four years and suggest a lower profile of interest rates, a weaker dollar, and a better equity market than otherwise would have been the case.

Oil prices: As measured by refiners' acquisition costs, oil prices are assumed to drop another $1 to $2 a barrel over the next six months. OPEC oil production rises with seasonal demands, and Saudi Arabia increases production to 4.3 million barrels per day. Saudi netback arrangements reduce spot crude oil prices to near $26.50 per barrel by early spring.

Agricultural prices: Continuing weakness in most basic commodities and agricultural prices for the rest of this year, reflecting large supplies and the slack demands of weak economies throughout the world. Commodity prices begin to firm during 1986.

Wages and unit labor costs: In general, continuing downward pressure on wages from economic slack, the effects of deregulation, increased competition, and the decline in union strength. While contract negotiations should be slightly more favorable to labor this year and next, a tough stance by management is assumed to keep labor cost increases modest--about 3% per annum for this year and next.

Third World debt and bank problems: The debt problem is turning more critical. Mexico was out of compliance with its IMF program and in financial difficulty before earthquakes rocked Mexico City. At the United Nations, Latin American debtors blasted the IMF. Peru threatened to quit the Fund. With the IMF/World Bank annual meetings coming up, the debt crisis will become more visible. The bank-to-government via IMF dialogue may well be unravelling in favor of more government-to-government discussions. LDC debt and its fallout is a constraint to growth.

Growth in the rest-of-the-world economies: The economic expansion in developed countries is expected to be sustained through 1985 and 1986. European countries continue to grow at moderate rates of about 2% to 3-1/2%, with some improvement for inflation but little on the unemployment front. Growth rates in Canada and Japan will exhibit a slowdown in 1985 and 1986 as a result of a slowdown in U.S. economic growth, but will remain relatively high--at about 4% to 5%. Likewise, Far Eastern countries such as Taiwan, Singapore, Korea, and Hong Kong--highly dependent on exports--will suffer as a result of declining U.S. imports in late 1985 and 1986. Latin American countries will also be affected by reduced U.S. imports but, excluding Mexico, will show a small but positive growth.

Alternative possibilities and probabilities: An alternative to the baseline (Higher Rates Scenario, probability = 10%) assumes above-target money growth and strong economic growth in the second half of the year. The higher monetary growth is associated with higher inflation and higher interest rates, which push the economy into a recession by the latter part of 1986. A second alternative (Fizzling Out Scenario, probability = 15%) assumes that the economy fades into recession this year, fizzling out from weak foreign trade, slack in consumer spending, and too long a delay in easing by the central bank. Once the recession occurs, monetary growth eases and the Fed aggressively loosens policy. Interest rates decline by one to two percentage points over the next year in this scenario. Finally, a third projection (Lower Inflation Scenario, probability = 5%) assumes a sharp decline in oil prices that leads to lower inflation, reductions of interest rates, and higher growth rates than in the baseline forecast.

Trade legislation and tax reform: The G-5 agreement is assumed to result in coordinated periodic interventions against the dollar--mostly by Japan and West Germany--speeding up and intensifying the dollar decline that began in late February. A slight notch of easing late in the year by the U.S. central bank, after monetary growth eases, helps to keep the dollar down to levels near 2.5 deutschemarks, 210 to 215 yen, and 8 French francs--levels to which the dollar would have fallen anyway, but not until next year.

negative for the economy. If consumption spending should fade in the fourth quarter and beyond, then it is hard to see how business fixed investment can improve much.

Finally, inventory accumulation was down in the third quarter compared with the second, undoubtedly the result of a decumulation of auto inventories. Since 1986 auto sales have been borrowed against in exchange for third quarter sales, auto makers may well be caught with excess inventories in relation to sales in the new model year, and cut back later.

As Table 8 shows, consumers are heavily in debt, with outstanding debt relative to income at postwar highs and delinquency rates on mortgage and installment credit sharply higher. With the personal saving rate below 3%, some retrenchment in consumption is inevitable. What is keeping household spending and borrowing up appears to be still reasonable monthly loan repayments, both for mortgages and auto loans, relative to income, compared with historical experience. But, with these financial statistics, consumer spending almost certainly will fade.

For the fourth quarter, growth is likely to weaken to about a 2-1/2% pace, reflecting a slowdown in consumer spending and less improvement for net exports, if any, compared with the third quarter. Stronger growth may well be generated by a rebound of inventories, but this would be a sign of weakness rather than strength, especially if inventories were built up in the automotive sector.

The Shearson Lehman economic forecast presents a "muddling-through" scenario for the next couple of years. The expansion should continue, getting a second wind from lower inflation, lower interest rates, and a lower dollar. If all else fails, the central bank will step in to keep the economy expanding. The harmful effects of recession in the U.S. and world economies far outweigh the risk of reinflation. Sustained growth thus is likely, but probably subpar in 1985 and 1986, with a one-in-four risk from recession.

The reduced inflation, lower interest rates, lower dollar, and accommodative Federal Reserve policy envisioned do not insure growth in the 3% to 4% range and a decline of unemployment, however. More of a fundamental correction in the policy mix is required.

For next year, an improvement in net exports should contribute most to improved growth, with only modest increases for consumption spending and business fixed investment. Housing and residential construction are expected to be firm, but not to rise much. Business will keep inventories lean in relation to sales. And, federal government spending is forecast at a 3.1% annual rate, compared with 8.7% in 1985.

Table 8
Consumer Behavior: Financial Indicators

	Quarters			Years*			
	1985:3F	1985:2	1985:1	1984	1980	1970	1960
Consumer Indebtedness							
Consumer Credit, Total**	672.2	644.0	614.7	548.1	385.1	141.3	63.6
(% change, annual rate)	18.7	20.5	549.3	9.2	10.5	11.8	--
(as a % of disposable income)	24.5	23.6	23.2	21.3	21.1	20.3	18.1
Installment Credit	540.0	517.1	493.0	517.1	311.2	104.1	43.9
(% change, annual rate)	18.9	21.0	22.4	13.5	11.6	9.0	--
(as a % of disposable income)	19.9	19.0	18.6	17.0	17.0	15.0	12.5
Other Consumer Credit	132.2	127.0	121.6	109.6	73.9	37.2	19.7
(% change, annual rate)	17.6	18.7	20.7	10.4	7.1	6.6	--
(as a % of disposable income)	4.9	4.7	4.6	4.3	4.0	5.3	5.6
Home Mortgages	1449.1	1407.7	1372.9	1281.3	930.5	284.9	133.1
(% change, annual rate)	12.3	10.5	9.9	8.3	12.6	7.9	--
(as a % of disposable income)	53.4	51.6	51.7	49.7	50.9	41.0	37.8
TOTAL	2121.3	2051.7	1987.6	1829.4	1315.6	426.2	196.6
(% change, annual rate)	14.3	13.6	13.5	8.6	11.9	8.0	--
(as a % of disposable income)	78.2	75.3	74.9	71.0	71.9	61.3	55.9
Debt Service							
Mortgage Repayments ($ per month)	709	729	738	702	584	140	84
(as a % of median family income)	29.6	31.1	32.1	31.9	33.3	17.0	18.0
Newly-Built Homes							
Fixed Rate	639	705	719	684	--	--	--
Adjustable Rate	603	649	655	659	--	--	--
Existing Homes							
Fixed Rate	610	626	624	616	--	--	--
Adjustable Rate	570	581	590	590	--	--	--
Auto Loan Repayments ($ per month)	250	242	243	253	183	161	--
(as a % of median family income)	10.5	10.3	10.6	11.5	10.8	19.6	--
Interest Payments on Installment Credit as a % of Disposable Income	3.4	3.3	3.2	3.2	2.5	1.6	1.1
Interest Payments on Mortgages as a % of Disposable Income	7.2	7.2	7.2	7.3	5.6	3.6	2.5
Interest Payments on All Debt as a % of Disposable Income	10.6	10.5	10.4	10.4	8.1	5.2	3.6
Delinquency Rates							
Installment Credit (%)	2.38	2.32	2.26	1.96	2.61	--	--
Mortgages (%)	6.40	6.30	6.19	5.66	4.98	3.13	2.41
Other Household Measures							
Financial Assets/Liabilities	250.9	250.8	252.3	251.4	237.7	340.0	386.8
Real Financial Assets	2334.1	2302.2	2249.8	2157.3	1811.9	1566.1	1080.7
(% change, annual rate)	5.7	9.6	18.3	4.5	1.5	3.8	--
Net Worth (net of depreciation)	12390.0	12142.0	11951.2	11660.5	8933.0	3171.0	1751.7
(% change, annual rate)	8.4	6.5	10.4	6.9	10.9	6.1	--
Real Net Worth (net of dep'n)	5434.2	5367.6	5321.1	5233.6	4763.5	2947.8	2411.8
(% change, annual rate)	5.1	3.5	5.9	2.4	4.9	2.0	--

F=Shearson Lehman Brothers forecast.

*Percent change is as of the previous indicated year, at an annual rate.

**Consumer credit includes short- and intermediate-term installment and noninstallment credit extended to individuals through regular business channels to finance the purchase of consumer goods and services.

Inflation rates are expected to fluctuate between 3% and 3-1/2%, tilting upward as 1986 progresses because of a lower dollar. The dollar should drop another 10% or so from current levels over the next year, reflecting negative fundamentals and periodic intervention by the G-5 countries. Profits are forecast to do better in 1986 than 1985, rising by about 7% because of cost cutting, earnings translation under a weaker dollar, and improved sales. The projections also show monetary growth moving to within target ranges for the next year and interest rates stable to somewhat lower. Stock prices enjoy a modest rise as a result.

How can the expansion continue? The economic slowdown has not been all bad; indeed, it has probably enhanced the potential for sustained, albeit subpar, growth. By-products include lower inflation, lower interest rates, and a lower dollar which, in turn, enhance the prospects for future growth. The growth recession has opened up more slack in the economy, adding to downward pressure on prices and wages. Ample supplies of food commodities and less demand for oil imports also have helped to drive prices down. The slowdown has been associated with lower interest rates, with demand-side weakness bringing declines as well as periodic easings of monetary policy. Finally, a lower dollar is a consequence of slow growth and the reductions of interest rates that have occurred.

Lower inflation enhances household and business purchasing power; lower interest rates increase the affordability of durable goods and reduce the costs of financing for households; and the lower dollar should, with lags, act to reduce imports and increase exports. All of these are necessary in order for the expansion to be sustained.

The relatively sanguine forecast of sustained growth depends on a number of critical assumptions, most having to do with economic policy.

First, it is assumed that the budget tightening of the past summer results in slowed economic and monetary growth, thus permitting more leeway for the Federal Reserve to be accommodative or to ease somewhat to sustain growth. Second, the Federal Reserve is assumed to ease later this year, helping to reduce real interest rates and the dollar another notch. This assumption is open to question, however, given the rapid decline in the dollar already and the growing potential for a dollar-induced reinflation. The central bank fears this eventuality. Third, no major protectionist legislation is assumed, a somewhat risky view unless the U.S. industrial sector improves greatly over the next year. Fourth, tax reform is assumed to be neutral in its impacts on macroeconomic growth. The risk is that as it currently stands, the tax increases for business in the proposed legislation could bring a major slowdown in the first year of passage. Fifth, the G-5 intervention is assumed to accelerate the decline of the dollar, since the dollar would have dropped anyway, helping to speed a turnaround in foreign trade.

However, the risk here is that without underlying fundamental reforms in the monetary and fiscal policies of the United States and rest of the world, no lasting improvement can occur for the U.S. industrial sector. Sixth, it is assumed that weakness in the goods sectors is not carried over into the services sectors, so services activities can keep carrying the economy higher. Seventh, oil prices are expected to decline further, offsetting the potential reinflationary effects from a weaker dollar.

Risks of Recession, Potential Impacts on the Budget, and Effects on the Debt Burden

There are a lot of "ifs" in the forecast, so much so that the risk of recession must be regarded as one-in-four. How would a recession arise? One way is through a fizzling out, a fading into a downturn as demands weaken and the competitive pressures on the tradable goods sector take their toll. The other eventuality leading to a recession would be a dollar collapse, stronger growth than expected because of improving net exports, excessive monetary growth, accelerated inflation, higher interest rates, and restriction by the Federal Reserve.

With the economy about to enter the fourth year of expansion, the possibility of a recession is well within the historical averages. For the postwar period, the average length for expansions has been 44.3 months. Excluding war years, the average length is near 34 months.

So far, the classic characteristics that precede a recession are not present. These include, but are not limited to, output nearing capacity, bottlenecks and shortages, upward pressure on prices and wages, heavy credit demands, rising interest rates, a tightening of Federal Reserve policy, rising inventory:sales ratios, and often a credit crunch. Currently, the only excess that has been present has been a mild accumulation of unwanted inventories, which has been in the process of correction now for some months.

A more traditional pattern could arise in the current environment, however, through the mechanism of the dollar, international trade, and international finance. The decline in the dollar might turn into a freefall, if foreign holders of dollar-denominated assets begin to turn away from the currency. This can happen because of expectations that the dollar is headed lower, out of disenchantment with the prospects for the U.S. economy, from improved prospects in other countries, or a resurgence of inflation from the dollar decline itself with lags, the declines in the dollar with lags should produce increased real economic growth through a turnaround in foreign trade and also higher inflation. The extent of the inflation reaction from a lower dollar is uncertain, but it is now becoming better known that the disinflation of the past five years was very much an effect of a strong dollar, suggesting a possible sharp upward effect.

Increased real economic growth and higher inflation could fuel a surge in monetary growth, forcing the central bank to tighten monetary policy. In this situation, many of the traditional pre-recession features would arise. A recession would likely occur in late 1986 or early 1987, worsening the deficits further.

Table 9 shows the sensitivity of federal budget deficits to changes in real economic growth, inflation, the unemployment rate, and interest rates, as estimated by Shearson Lehman Economics.

Table 9
Impacts of Growth, Inflation, Interest Rates, and the Unemployment Rate on Budget Deficits
(Billions of Dollars, Fiscal Years)*

	1986	1987	1988
Case 1	4.4	13.0	15.6
Case 2	4.4	18.6	37.0
Case 3	3.6	8.0	8.1
Case 4	3.6	12.1	21.3
Case 5	2.6	5.0	5.2
Case 6	3.0	9.0	14.0

Case 1 = 1% more real GNP growth, one time, 1986:4 over 1985:4.
Case 2 = 1% more real GNP growth in each year.
Case 3 = 1% more inflation, one time, 1986:4 over 1985:4.
Case 4 = 1% more inflation every year.
Case 5 = 1 percentage point lower unemployment rate starting in 1986:1 but no change in real GNP.
Case 6 = 1% percentage point lower interest rates in each year, 1986 to 1988.

* Positive figures represent reductions in the deficit.

Weaker real economic growth can be seen to have the biggest impact on the budget deficits. Real economic growth of two to three percentage points less over the next three years would raise the budget deficits by anywhere from about $10 billion in FY1986 to $75 billion in FY1988. The higher inflation would reduce the budget deficits, however, offsetting some 50% to 60% of the worsening. Higher interest rates, perhaps two to four percentage points under a tighter monetary policy, would raise the deficits significantly. All-in-all, under the traditional path to a recession by late 1986 or 1987, the FY1988 budget deficit might reach $250 billion to $270 billion.

Shearson Lehman assigns a probability of 10% to this prospect.

The second way to a recession would be through a fizzling out of the current expansion. While normally not the manner by which a recession occurs, the current business cycle experience is quite different from previous ones. An autonomous increase in savings by households, already overextended in borrowing and spending relative to income, could drive the economy lower quite soon. The weakness in the industrial sector, which seemed to intensify in September, is another factor suggesting a possible near-term recession. In this situation, the economy could decline soon, late this year or during the first half of 1986, with real economic growth dropping sharply. However, in this situation, inflation rates likely would drop further, interest rates would decline, and unemployment rise, creating higher budget deficits but not so much as would be the case in the more typical approach to a recession. Lower real economic growth might cost some $8 billion to $35 billion in additional deficits over the next two fiscal years. Lower inflation would add another $4 billion to $15 billion to the deficits. But, sharply lower interest rates could subtract $6 billion to $18 billion from the deficits over the same time period. Higher unemployment might add $5 billion to $10 billion to the deficits. The result would be deficits on the order of $210 billion to $215 billion in FY1986 and $230 billion in FY1987, compared with the $202.3 billion and $192.5 billion in the baseline Shearson Lehman forecast. The deficit would be higher than the $173.6 billion projected for FY1988, but improving compared with FY1987.

The odds on this possibility are assessed at 15%.

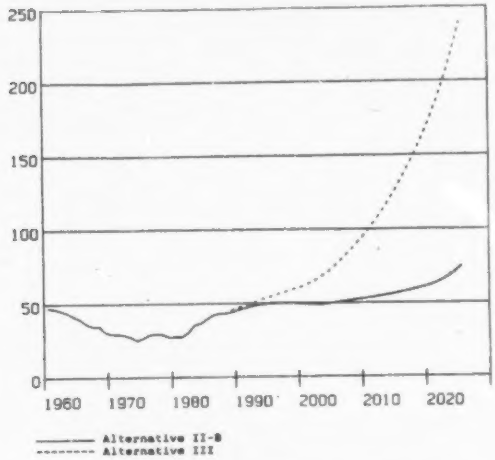
Thus, the risks of recession total 25%, and with it the possibility that much higher deficits, a larger volume of Treasury financing, and the debt interest charges could escalate even more than in the baseline scenario.

Charts 2 and 3 show the pattern of debt relative to GNP and of interest charges relative to GNP under a "worst" case and "more optimistic" scenario for economic growth, inflation, and interest rates.

The dotted lines show the results of more pessimistic projections about real economic growth over the next 40 years, along with the interest rate forecast of Shearson Lehman Economics. The solid line shows the results if growth is more rapid than recently and interest rates on short- and long-term government debt average around 7% or 8%. The dotted line is the result of any sequence of events that might produce periodic recessions, originally set into motion over the near term.

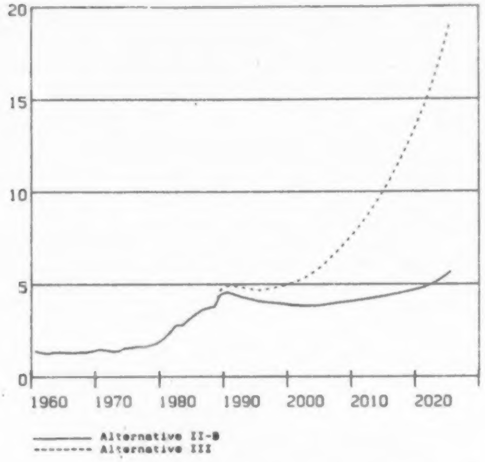
Probably, the truth lies somewhere in-between, but the possibility of explosive growth in outstanding federal government debt relative to GNP or in debt service as a percentage of GNP is distressingly high; perhaps the most compelling reason for cutting deficits.

Chart 2
Outstanding Federal Government Debt
as Percentage of GNP
(History and Forecast*)



* Projections from 1988 to 2025 are based on the Social Security Administration's long-term economic and demographic assumptions (alternative II-B and III) while the budget projections and interest rate forecast are from Shearson Lehman Economics.

Chart 3
Debt Service as Percentage of GNP
(History and Forecast*)



* Projections from 1988 to 2025 are based on the Social Security Administration's long-term economic and demographic assumptions (alternative II-B and III) while the budget projections and interest rate forecast are from Shearson Lehman Economics.

Budget Deficits, Policy Mix, and Economic Impacts

As an approximation to the potential effects of further reductions in the budget deficits, such as might be embodied in the Gramm-Rudman amendment to the debt ceiling bill, the Shearson Lehman Model of the U.S. Economy was used to simulate the impacts of reductions in the deficits over the next few years, achieved through changes in spending. Table 10 summarizes the results.

Table 10
Effects on U.S. Economy from Spending Cuts:
Fiscal Years 1986 to 1988*
(Changes from the Baseline, No Compensating Fed Ease)

	1986	1987	1988
Federal Govt. Spending (Bils. Dols.)	-33	-66	-105
Real GNP (% Chg.)	-1.0	-0.7	-0.6
Final Demands (Bils. 72 Dols.)			
Consumption	-2.0	-4.9	-8.2
Bus. Invest.	0.1	0.8	2.1
Net Exports	1.3	6.6	11.2
Housing Starts (Mils. Units)	.008	.020	.070
AAA-Equivalent Bond Yield (Basis Points)	-60	-115	-169
Federal Funds Rate (Basis Points)	-17	-85	-182
Deficit (Bils. Dols.)	-26.6	-48.2	-75.8

*Computer simulations with the Shearson Lehman Model of the U.S. Economy. Computer simulations with an econometric model should be regarded as producing an approximate outcome--the central tendency of a distribution of possibilities given the change in policy and structure of the economy as assumed in the model, provided that the policy shock is within the range of historical experience.

The reductions in federal government spending necessary to close the deficit gap, after feedback, range from $33 billion in 1986 to $105 billion in 1988. The result is weaker real economic growth, with a bigger impact in the first year of the fiscal restraint. The mix of final economic activity shifts, with weaker consumption spending and less accumulation of inventories, but somewhat stronger business fixed investment and much more activity in net exports, intereet rate and dollar sensitive sectors. Housing activity also is indicated to be higher.

The reduced government spending lowers interest rates, both short- and long-term, anywhere from 60 basis points to 169 basis points over the next three years for long-term corporate bonds and in a range of 17 basis points to 182 basis points for short-term interest rates.

If the economy were already growing very slowly, the fiscal restraint might well tip the economy into recession. The weaker monetary growth associated with the slower pace of growth in the economy would permit considerably more leeway for the Federal Reserve to ease, if desirable.

Economic Policy and Sustaining the Expansion

To sustain the expansion at a pace that is adequate for reducing unemployment requires further declines in interest rates and the dollar. How can this be engineered through economic policy?

Crisis management action such as the G-5 intervention can accelerate declines in the dollar and speed an improvement in foreign trade. But without changes in the underlying policies of the countries concerned, a lasting improvement is difficult to achieve. Fundamentally, if the U.S. budget deficits are still too large and monetary policy tighter than necessary, real interest rates and the dollar will be too high to sustain the expansion at the 3% to 4% rate that would bring the unemployment rate down to a full employment zone.

There are several policy options available. First, and ideally, would be further reductions in the federal budget deficits. Such a tightening should be offset by a compensating ease in monetary policy. By a compensating ease is meant injections of bank reserves to raise monetary growth to the levels that would have existed before the budget tightening. The effects of such a policy twist would be lower nominal and real interest rates, a drop in the dollar, and higher equity prices. Little change in overall growth should be expected. But there would be a decided shift in the composition of economic activity, with increased growth in the goods sectors and less activity in the services sectors. Although slow in coming, U.S. industries probably would begin to regain some of lost market shares.

At this point, much less is required to close the remaining deficit gap. With the string having run out on reductions in spending as a means to reduce the deficits, higher taxes or increased growth provide the alternatives for further deficit gap closing. Full employment budget calculations provide estimates of the reductions yet necessary, estimated to be $117.4 billion in FY1988. Another possibility is a sufficient amount of deficit reductions to lower the unified budget deficit to approximately $100 billion in FY1988, or 2% of nominal GNP, the target originally set by the Congress and Administration. In the latter case, about $75 billion of deficit reductions by 1988 would be necessary.

Table 11
Full Employment Budget Deficits:
Pre- and Post-Concurrent Budget Resolution*

	No Budget Savings		Concurrent Budget Resolution	
	Bils. of $'s	Percent of GNP	Bils. of $'s	Percent of GNP
1985	140.0	3.5	140.0	3.5
1986	170.8	4.0	136.5	3.2
1987	172.0	3.7	126.4	2.7
1988	184.6	3.7	117.4	2.4

*Full employment unemployment rate assumed at 5.5%; potential real GNP growth estimated at 3%.

How much of the deficits can be eliminated through increased economic growth?

The federal budget deficits are most sensitive to interest rates, growth, inflation, and the unemployment rate. An easier monetary policy that reduced interest rates by one percentage point could reduce the budget deficit by about $14 billion in FY1988. If, at the same time, one percentage point of additional real economic growth was induced, another $37 billion of deficit reduction might occur. If inflation were one-half percentage point higher and the unemployment rate 0.3 percentage point lower, then by FY1988 another $5.5 billion reduction in the deficit could be achieved. The total of $56.5 billion by FY1988 would reduce the estimated deficit to $117.1 billion, just $17.1 billion above the $100 billion or 2% of nominal GNP target. Only a very modest tax hike would then be required to eliminate the remaining $15 billion to $20 billion, perhaps to be accomplished by an oil import surcharge or a tax proposal that did not lower marginal tax rates so much as in the Administration's tax proposals.

A second possibility is for the Federal Reserve to ease in order to defuse the current situation. Such action may be inevitable, but ultimately cannot work unless the budget deficit also is reduced. Loose fiscal and loose monetary policy can only produce higher inflation and higher interest rates in the long run. Without further deficit reductions, the central bank would only ease slightly.

A third possibility is continuing intervention to drive the dollar down enough to eliminate the current account deficit. More currency reserves than are available to the G-5 countries would be necessary, however. And, a lower dollar would set up pressure for higher interest rates, thus self limiting.

Clearly, most choices cannot necessarily produce a sustained expansion. Only a further redressing of the unbalanced policy mix offers assurance of sustaining the expansion, with a tighter budget providing the central bank with much more room to ease.

The Gramm-Rudman Amendment

The Gramm-Rudman Amendment passed by the Senate offers one possible way to close the remaining deficit gap, setting up a pattern of spending reductions of $36 billion a year from the estimated FY86 budget deficit.

The Amendment is set up to require across-the-board reductions in nondefense and defense spending if deficits exceed the ceilings set each year and the Administration and Congress do not agree on how to reach the ceiling. Neither the Congress nor the President has a great deal of leeway in any arbitrary choice of spending reductions, although some new power does shift to the Executive. Social security payments and interest payments are exempt. About 50% of the budget would be available for cuts under this program.

Certainly, a phased-out series of reductions in the budget deficits through additional spending cuts would be a positive approach to eliminating federal budget deficits, reducing interest rates, and reviving activity in interest and dollar sensitive sectors. Also, such a budget tightening could induce a Federal Reserve easing. Tax increases also might be possible, but more contentious if opposed by the President.

There are other problems. One is that a too heavy cutting of the budget might be required if deficits were very large relative to the ceilings. The Congress and Administration might be in a position of having to tighten fiscal policy sharply and perhaps propel the economy into a recession. Second, the funds available to be cut may be inadequate given the task of the budget tightening that is required. Programs, both nondefense and defense, might be slashed when, in fact, they were desirable. Third, some threat to national security is possible, depending on international events. Fourth, the automatic nature of the Amendment precludes sufficient deliberation as to which programs should be cut. If exceptions and overrides were begun on some matters, then the plan might not produce the desired result or be overturned.

Once again, this Amendment is an example of crisis management which begs the basic issue of correcting budget deficits originally caused by massive tax reductions.

With adjustments to remove some of the weaknesses, the Gramm-Rudman approach may well serve as an appropriate mechanism to stage in budget deficit reductions, in a necessary budget cutting to correct the existing imbalances in fiscal policy. If such a program were enacted, it is equally important for the central bank to provide a significantly easier monetary policy as well.

Summary

Budget policies have had and are having a major impact on the performance of the U.S. and world economies. Massive tax cuts were responsible for the superlative performance of the U.S. economy in 1983 and 1984 and the revival in growth for the rest-of-the-world economies as well. But the very policies that created that strength also led to an unprecedented string of budget deficits which are now responsible for most of the negatives that characterize the economy.

The current negatives--which include stagnant economic growth in the U.S., weakness in profits and incomes, still high real interest rates, a still strong dollar, intense foreign competition, continuing loss of market shares in tradable goods to the rest of the world, essentially a recession in goods-producing industries especially manufacturing, the inflationary tied of a declining dollar, the rising threat of protectionism, and monetary policy that is hamstrung because of a declining dollar and excessive monetary growth--stem from the loose fiscal-tight monetary policies of previous years. Unless reversed, such a policy mix in an open economy with flexible exchange rates must ultimately produce stagflation and a slow demise of the industrial base.

Recommendations:

1) The Administration should declare its intention to eliminate the structural budget deficits by 1990, raising taxes within the framework of the new tax reform proposals and urging that other countries stimulate their economies. The shift in the policy mix of the U.S. and its trading partners should be accomplished gradually, but in a planned and coordinated manner over the next five years and staged to prevent dislocations in financial markets.

2) At the same time, the Federal Reserve should declare its intention to contribute to deficit reduction by engineering lower interest rates and higher economic growth than recently, providing a compensating ease in monetary policy to offset the fiscal restraint that balances the budget.

3) Through these actions, the path to deficit reduction would eventually end up including the spending reductions accomplished by the Congress in 1985; tax increases; and an increase of economic growth--a combination that could reduce the unified budget deficits to 2% or less of nominal GNP by FY1988.

4) The Finance Ministers and the Treasuries of G-5 countries should agree that intervention will be used to maintain orderly movements in currencies as shifts in the policy mix are achieved.

5) Selective legislation designed to "protect" those industries in the United States that suffer "unfair" trading practices from abroad should be designed and implemented. Protectionist legislation involving general tariffs, surcharges, or quotas should be avoided.

6) The President's tax reform proposals, modified so that revenues are raised as part of a package to eliminate deficits, should be enacted, accomplishing in one fell swoop marginal tax rate reductions, base broadening, and revenue enhancement to help eliminate the excess budget deficits and create a more equitable and efficient tax system.

What would be the impacts of this coordinated policy attack on the current problems? Most likely, a new lower profile of interest rates would be established, the dollar weaken, equity prices improve, and the composition of output shift toward a rebalancing of the unbalanced growth in goods and services activities. Most important is the insurance of sustained expansion these policies would buy. The lower interest rates would contribute to an easing of the problems of the LDC countries. The weaker dollar would improve the prospects for countries who must pay debts in dollars. And, sufficient economic growth could be achieved to bring the unemployment rate lower.

Sooner or later, policymakers will realize that the only solution for current difficulties lies in rebalancing the unbalanced mix of monetary and fiscal policies in the United States and abroad. Twisting the U.S. policy mix to a tighter budget and easier monetary policy and reversing this twist abroad are necessary. A coordinated attempt to do so is preferable to a coordinated attempt to drive the dollar down through currency intervention. It is better to move soon toward more permanent solutions than to keep reacting in a crisis management fashion that might fail to sustain the expansion.

The CHAIRMAN. Thank you, Dr. Sinai.

Unfortunately, we have a vote that is going on right now; in fact, it is on the rule for the textile bill.

You spoke of some measures that grow out of the deficit problem and our international loss of position. This is one of those. Therefore, what I would like to do is, I would like to submit some questions to you, which I would like for you to answer to me—as I have already had an opportunity to question your colleagues. But I think you have already answered most of my questions.

I would like to thank you, Dr. Chimerine, Dr. Behravesh, and Dr. Sinai. Your testimony has been extremely helpful. It will be distributed to all members of the committee and be available for the record for all Members of the Congress.

I want to thank you gentlemen. Unfortunately, I must run. I have 1 minute to make it to the floor to vote. Thank you very much.

[Whereupon, at 12:10 o'clock, the committee adjourned.]

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